The Canadian Chartered Accountant

The Income Statement
By J. H. Thompson

Defects in Published Accounts
By Cecil A. Ellis

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By N. R. Moran

$4.00 a year **NOVEMBER 1948** 40c a copy

The Canadian

Chartered Accountant

Official Organ of

The Dominion Association of Chartered Accountants

Incorporated 1902

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Published monthly
$4.00 a year 40c a copy

Address all communications to
The Canadian Chartered Accountant
10 *Adelaide St. E., Toronto* 1, *Ont.*

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

Constituent Institutes
The Institutes of Chartered Accountants of
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Authorised as second class mail by the Post Office Department, Ottawa.

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Volume 53 **NOVEMBER 1948** Number 5

EDITORIAL COMMENT

Tax Directives and the Rule of Law

GEORGE CANNING once said: "Away with this cant of government by laws and not by men! As if it is the reins and not the horses which draw the carriage!" Great Parliamentarian that he was, Canning certainly did not mean that we should replace our laws with an autocracy of the elite answerable to no-one, for laws we must have if we are to live together in community. Admittedly, however, laws are mere scribblings until they are put into effect, and it is then that men must be called in to administer them. But it is not to be forgotten that it is the law and only the law which they are to administer, and (under our free system) not the administrators who are the law. In this country that issue was settled once for all just one hundred years ago; in the mother country it was settled a century and a half before that.

These observations may seem unduly weighty for the occasion which produced them, though we think not. On October 20th the Ministers of Finance and National Revenue issued a joint statement announcing the cancellation of a directive issued by the Taxation Division on September 9 which cancelled a prior directive of October 1, 1947, which itself cancelled a then existing departmental ruling to the effect that the rental value of a manse occupied rent-free by an ordained clergyman should be included in the computation of his income for taxation purposes.

This sequence of cancellations of administrative rulings is not an edifying picture. As an illustration of government by men and not by laws it adds the exclamation point to the successful outcome of the great constitutional struggle for responsible government.

We do not suppose for a minute that any Canadian Government or Cabinet Minister or senior official has any predilection opposed to the rule of law. Unfortunately, however, the situation as described has developed, and developed inevitably because of the lack of adequate provision in the income tax law for recourse to the Courts for construction of its provisions. Until the amendment of 1946 establishing an inexpensive mode of appeal to a Tax Appeal Board (still un-appointed, we hasten to add), the expense and delays incident to an appeal from an income tax assessment were

so burdensome as to confine appeals to issues involving large sums of money. The vast majority of taxpayers had their recourse only to the officers of the National Revenue Department, the self-same persons who assessed the tax. In effect this is a violation of the most fundamental principle of justice, namely, that a party to a dispute cannot be judge in his own cause.

In this matter of the chargeability to tax of a clergyman's rent-free manse, the legal issues involved would seem to be simple enough. There are decisions by the English Court of Appeal (*Reed v. Cattermole* (1937) 21 T.C. 35) and the Scottish Court of Session (*Commissioners of Inland Revenue* v. *Leckie* (1940) 23 T.C. 471), which have held that the occupation of a rent-free manse by a clergyman as an obligation imposed on him by the terms of his appointment is not an emolument of office but a condition of his employment. The Canadian Act does not seem to be essentially different from the British Act on this matter. However that may be, surely this is the very type of question which the Courts are established to pass upon; and under the Canadian law such has been the limitation upon recourse to the Courts that we are faced now with the not pretty spectacle of a series of administrative pronouncements each cancelling the one before.

With the establishment of a new Tax Court, to which access will be both easy and inexpensive, the rule of law in tax matters should soon be re-established on the high pedestal which is its proper seat in this country. There need then be no special directives dealing with such matters as the assessability of clergymen's rent-free manses or with the expenses of members of the medical and dental professions in attending any one of certain specified Conventions. Under the former system of minimum recourse to the Courts the Department has willy-nilly had to express its view on a thousand and one aspects of the statute which it is required to enforce. That it should err this way or that is inevitable under the circumstances, and the sooner that situation is terminated the better for everyone concerned. 'Tis a consummation devoutly to be wished, by the tax officials no less than by others.

Travelling Scholarships

FURTHER to our recent note on exchanges of students between practising firms in Canada, we have been most interested to learn from *The Accountants' Journal*, the publication of the New Zealand Society of Accountants, that the Society has decided to award travelling scholarships to suitable members who wish to gain experience overseas. These scholarships will be of a value of £200 per annum and will be tenable for two years. Unless specially exempted, each scholarship holder, on completion of two years' residence abroad, shall be required to return to New Zealand and remain there for at least three years. The Society will furnish each scholarship holder with letters of introduction to suitable accountancy bodies overseas in order to help him in his efforts to obtain suitable experience.

The Replacement Problem

THE Committee on Accounting Procedure of the American Institute of Accountants has, since December, 1947, when it issued its Bulletin No. 33 on the subject of "Depreciation and High Costs", given intensive study to the problem of the accounting treatment of depreciation of plant and equipment under conditions of a changing purchasing power of currency. In Bulletin No. 33, as has been reported here before, it recognized that management must take into consideration the probability that plant

and machinery will have to be replaced at costs much greater than those of the facilities now in use. It also agreed that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels. But when it came to the proposition that the problem be met by increasing depreciation charges against current income, the committee felt that this would not be a satisfactory solution at the present time and that, before radical changes in accepted accounting procedure be undertaken because of higher price levels, we should defer decision until a stable price level would make it practicable for business as a whole to make the change at the same time.

Since the issue of that Bulletin, there has been a great deal of useful public discussion of the problem. We have published some views and we hope to publish more, as the controversy will be with us for some time yet. It is interesting to report therefore that the Committee has recently written to members of the American Institute of Accountants stating that after further study, which has involved the consideration of hundreds of opinions expressed by businessmen, bankers, economists, labour leaders and others as well as the views of the members, seventeen of its twenty-one members agree that the opinions previously expressed should be reaffirmed. It again recognizes that the immediate problem can and should be met by financial management and it gives support to the use of supplementary financial schedules, explanations or footnotes in addition to common forms of financial statements in order that the problem of management may be understood.

With this in mind, it is also of interest that much of the discussion in the United Kingdom on this subject stresses the plea that the immediate cure is to reduce corporation income taxation by the granting by legislation of special allowances for depreciation. Many corporation reports suggest this remedy, and one is left with the feeling that the problem arises solely because of high taxation. In other words, one gathers from a review of the British corporation reports that there would be no problem if there were no income tax. This is, of course, an unfair inference but it comes from a reading of the available material.

In the United States, the problem is being threshed out solely on the basis of a changing dollar and the real problem is brought to the fore in a very much better way. But a major point of the difficulty is to convince the stockholders, employees and the general public that a corporation must be able to retain out of profits, amounts sufficient to replace productive facilities at current prices if it is to stay in business. To blame it on the income tax dog appears to be a more expedient solution than to recast generally accepted accounting principles with the probability that everybody will become confused.

The problem is that enterprise must retain sufficient earnings to permit replacement of its productive facilities at any price level which may be current at the time replacement is needed. Despite what has been said frequently, we do not believe that selling prices are set by analyses or budgets on an accounting level. Neither do we believe that rates of dividend are set having in mind reported financial results only. We do not think our legislators will be very happy if the effect of changing accounting practices is to reduce collections from taxation or change the taxation code of administration.

All in all, we agree with the American Institute Committee. When the price

level stabilizes, and it must do so if we are to enjoy any peace or security in this world, it may be quite necessary to make an overall adjustment on a once-and-for-all basis. That is quite a different thing from the proposed revaluations of assets and liabilities on a continuing basis.

After all, inflation is a disease caused by humans. It must be cured by the co-operation, compulsion or common sense of humans. Tinkering with a currency system or with an accounting system will not of itself stop an inflationary spiral. That can only be stopped the hard way even though the end result of inflation is always the destruction or less of the capital of many, both corporations and individuals. The loss is, of course, the waste production thrown into war. That is a capital loss, there can be no question about that. When this loss is ascertained, realized and accepted, then we shall come back to a normal operation of a slowly rising standard of living with a consequent slowly falling value of currency. To the extent that standards of living rise at a rate in excess of the rate of decline of currency, we make the world a better place to live in. These rates, however, must be slow rates and their movement during the life of useful plant and equipment as manufactured and improved under modern conditions would not be great enough to require accounting adjustments beyond our present concept of depreciation computed on the basis of original cost.

On the practical side of the discussion, we wonder how much of the difficulty corporations now face results from investment of available funds in expansion. How many now find that what they should have done was to raise new capital for the expansion and hold their earnings accumulations for replacements? We should like to see statistics along these lines. For example, have the plants sold by various War Assets administrations been purchased for expansion or replacement purposes? Has the new machinery which has been flooding into Canada been for expansion or replacement purposes? We suspect that this would be a most interesting study and one answer may well be that the problem is much accentuated by imprudent financial management.

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The Income Statement

By Dean Joseph H. Thompson, B. Acc., F.C.A.
(*Dean of College of Commerce, University of Saskatchewan*)

An analysis of the Canadian approach to various aspects of the problem of income determination.

Introduction

THE PROBLEM OF income determination is one which is receiving a great deal of attention from accountants at the present time. This interest is reflected in the professional accounting journals by the number of published articles dealing with topics in this field. Such articles as that by our distinguished visitor from the United States, Mr. George D. Bailey,[1] entitled "The Increasing Significance of the Income Statement" published in the January issue of *The Journal of Accountancy* and that by Mr. George O. May on "Postulates of Income Accounting" in the August issue of the same Journal are splendid contributions to accounting literature and will do much to assist professional accountants to select standards of accounting procedure in income determination acceptable to the profession as a whole.

In this present discussion of the topic I shall make reference to the two articles mentioned and to other articles by writers to whom I am greatly indebted.[2]

Increasing Importance of Income Statement

As Mr. Bailey points out, the trend in accounting over the years has been the increasing importance of the income statement. It is more than a shift in emphasis from the balance sheet to the income statement. It is more than a recognition that the income account is more revealing of the corporation's financial affairs than is the balance sheet. The fact is that year by year more information is being demanded from the income statements of corporations by all segments of the social structure. If we as accountants are to maintain our position in so-

[1] George D. Bailey, C.P.A., President, American Institute of Accountants.

[2] Clem L. King, B.Com., C.A., Director of Research, Dominion Association of Chartered Accountants.

Daniel Borth, Ph.D., C.P.A., "Adjustment of Prior Year's Income" "*The Journal of Accountancy*", June 1948 pp. 470-474.

Virgil S. Tilley, C.P.A., "The Income Statement and its Significance in Financial Reporting" "*The Accounting Review*" July 1948.

Address delivered at the 46th Annual Meeting of the Canadian Association of Chartered Accountants, Regina, Sask., August 25, 1948.

ciety as the impartial interpreters of financial accounts and our reputation for integrity and ethical practices, we must recognize our social responsibility. Accounting is not static — it is a dynamic art, and being dynamic it is necessary for us to carefully examine our procedures in the light of changing conditions.

Legal Requirements of Statement of Profit and Loss

In Canada we have not gone as far with our published research as have our American friends. It is fortunate that we have such a well informed and progressive professional society whose ideals and objectives are so closely related to our own. Their published literature is of great value to us. The situation, however, with respect to published reports is very different in the two countries. The S.E.C. has greatly influenced the form and content of American reports, requiring a great deal more information to be filed and published than is required in Canada. The only legal requirement with respect to Annual Reports so far as I am aware is that our companies comply with the provisions of the enabling Act under which the company received its charter, which, in the majority of cases is the Dominion Companies Act.[3] Section 113 of that Act, with which you are all familiar, sets out the requirements of the profit and loss account. In this connection the Committee on Accounting and Auditing Research made the following pronouncement in its Bulletin No. 1 "A Statement of Standards of Disclosure in Annual Financial Statements of Manufacturing and Mercantile Companies".[4]

STATEMENT OF PROFIT AND LOSS

A summary of the information which should be set out in the annual profit and loss statement follows:

Profit from operations — In many cases it is desirable that there should also be shown the total of sales or gross income from which the profit from operations is derived.

Provision for depreciation, obsolescence and depletion — If desired, this information may be shown parenthetically or as a footnote to the statement.

Interest expense — If of significant amount, interest on funded debt, amortization of debt discount or premium and expense, and other interest expense should be shown separately.

Income from Investments — The amount applicable to securities of non-consolidated subsidiaries or affiliates should be shown separately.

Miscellaneous deductions from or additions to profits — If significant, profits and losses on sales of securities or capital assets and non-recurring profits and losses should be shown separately.

Taxes on income.

Profit or loss for the period.

It may be of interest, at this time, to recall that in the "Review of the Dominion Companies Act, 1934" the Association's Post-War Planning Committee expressed the following opinion with respect to Section 113.

"In our opinion it is desirable to re-write the whole of the section in such a way as to provide that statements of profit and loss, of *both public and private companies*, shall be drawn up so as to distinguish at least the following classes of income and expenses:

(a) the operating profit before including or providing for other items of income and expenditure which are required to be shown separately;

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[3]The Dominion Companies Act, 1934, King's Printer, Ottawa.

[4]Bulletin No. 1, Committee on Accounting and Auditing Research, Dominion Association of Chartered Accountants. Toronto. p. 7.

(b) income from investments in subsidiary companies;

(c) income from other investments;

(d) non-recurring profits and losses of significant amount including profits and losses of a special nature;

(e) provision for depreciation and/or obsolescence and/or depletion;

(f) amounts written off for goodwill or amortization of any other intangible assets;

(g) interest on funded or other indebtedness not maturing within one year;

(h) total remuneration paid to directors inclusive of all salaries, fees, percentages or other emoluments;

(i) contribution to pension plans;

(j) provision for taxes on income imposed by any taxing authority,

and the net profit or loss for the financial period.

"We further recommend that the information required with respect to directors' fees and invested income may be shown by way of a footnote if desired, and where depreciation, obsolescence and depletion are charged against manufacturing or operating costs by the company in its accounts, the amount of such depreciation, obsolescence and depletion may also be shown as a note to the statement of profit and loss instead of being an integral part thereof.

"We believe that the above recommendations should apply in the case of each subsidiary as well as to the parent company and should the accounts be consolidated, the amounts in respect of each of the above items should be reported in total in the consolidated accounts. In Section IV of this report we set forth our recommendations regarding the reporting of the remuneration of directors of public companies and such should be read in conjunction with the foregoing remarks.

"One important recommendation of the Cohen Committee[5] in respect to the profit and loss account is that there be added to the Act a provision that 'Profit and Loss account or income and expenditure account shall give a true and fair indication of the earnings or income of the period covered by the accounts and shall disclose any material respects in which it includes extraneous or non-recurring transactions or transactions of an exceptional nature. It shall further be provided that if in any such period a material change is made in the basis on which the account or any item therein is calculated, attention shall be called to the change, and to the effect thereof by way of a note on the account'."[6]

Our Committee agreed with the desirability of including such a general provision in our Canadian law and recommended that such be incorporated in the revised section 113.

It will be observed that the only material differences between the Bulletin and the Post-War Planning Committee's proposal is that the Bulletin makes reference to the desirability of showing the total of sales or gross income from which the profit from operations is derived and the Bulletin omits (f) "amounts written off for goodwill or amortization of any other intangible assets".

It will also be observed that in Section 113 the statement required to be submitted at the annual meeting is the statement of income and expenditure and that net operating profit shall be shown separately before certain deductions, ending with the balance showing net profit or loss for the period.

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[5]Committee of Board of Trade which made recommendations with respect to revision of English Companies Act.

[6]Review of the Dominion Companies Act 1934. The Post-War Planning Committee, Dominion Association of Chartered Accountants, Toronto pp. 21, 22.

For the purposes of this discussion I have made an examination of ninety published Canadian annual reports. I have also compared these reports with those issued by American companies. One is amazed by the lack of information contained in published Canadian profit and loss accounts when compared with those issued by American companies. The majority of Canadian companies do not go any further in the dissemination of information than the minimum legal requirements. This is understandable because the psychological reaction to an Act of Parliament is, this is what the Act requires—this is what we must do! The objectives in the reporting of business income should be to present useful information which will enable interested parties to make intelligent decisions. To quote Mr. Bailey, "The income statement must be as *sharp* a presentation of corporate income for the year as it is possible to make it".[7]

Our Bulletin No. 1 emphasizes the necessity of presenting useful information to shareholders, prospective investors and other interested parties, and emphasises the service which a Chartered Accountant may render in exercising his social and professional responsibility.

Service of Chartered Accountants

"One of the greatest services which a chartered accountant renders is the judgment which he brings to bear in examining a financial statement to see whether it does provide adequate information. If, in his opinion, a balance sheet, while conforming to the requirements of the Companies Act, still does not present fairly the financial position of the Company, he will urge that further information be given or he will report to the shareholders on its shortcomings".[8]

These remarks could equally well apply to the profit and loss statement.

The following quotation is particularly applicable to present conditions:

"Neither directors or auditors can properly regard legal requirements as setting the measure of their obligation to shareholders; it is incumbent on all parties interested to work continuously to improve standards, and by precept and example, to endeavour to secure a reasonable degree of publicity in corporate accounts."[9]

Examination of Ninety Canadian Published Reports

I suggested a few moments ago that I had examined a number of published Canadian reports. May I make a few remarks with respect to these reports with the object of focussing attention upon those points which you may consider worthy of further discussion.

Terminology

Canadians prefer the title statement of profit and loss, or profit and loss account to statement of income and expenditure. Sixty-eight of the statements examined carried a *"Profit and Loss"* title, while twenty-two carried "Income and Expenditure" or some similar title. Of the companies examined, sixty-nine showed the "Net Profit or Income for the Year" at some stage in the account, not always as an end figure and not always having the same meaning. Other terms used were "Balance transferred to earned surplus", "Income transferred to Distributable Surplus" or some such designation.

Twenty-two companies presented some form of combined profit and loss and

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[7]George D. Bailey, "The Increasing Significance of the Income Statement", *The Journal of Accountancy*, New York, January 1948 pp. 10-19.

[8]Bulletin No. 1, Committee on Accounting and Auditing Research, *op cit.*

[9]George O. May, "Twenty-five Years of Accounting Responsibility" (New York, Price, Waterman & Co. 1946).

surplus statement and nine presented a comparative statement which added considerably to the value of the report.

Form and Content

The majority of companies presented some adaptation of the "add and deduct step" form of statement following very closely the requirements of the Act as shown hereunder, but there was no indication of uniformity of presentation.

Profit from operations before taking into account the items shown below		$x,xxx,xxx
Add: Interest on investments		xx,xxx
Profit arising from sales of investments, plant etc.		x,xxx
		$x,xxx,xxx
Deduct: Provision for depreciation		xxx,xxx
Company's contribution to employees' retirement income plan		xx,xxx
Directors' fees		x,xxx
Legal fees		x,xxx
Remuneration to executive officers		xxx,xxx
Debenture interest		xx,xxx
		$ xxx,xxx
Net profit for the year before providing for taxes on income		$x,xxx,xxx
Deduct: Provision for Dominion and Provincial taxes on income		x,xxx,xxx
Net profit for the year		$x,xxx,xxx

One of the less informative statements read as follows:

Profit from Canadian Operations before providing for the undernoted Charges		$x,xxx,xxx
Less: Debenture interest	$ xxx,xxx	
Depreciation	x,xxx,xxx	
Provision for taxes on income	x,xxx,xxx	
		x,xxx,xxx
Net profit for the year		$x,xxx,xxx

The following items were incurred during the year:

Fees and remuneration to directors exclusive of those holding salaried employment	$ xx,xxx
Remuneration to executive officers including directors holding salaried employment and legal fees	xxx,xxx

Eighteen companies showed the sales figures and additional information with respect to cost of sales etc., in a functional type of statement.

Much more information was exhibited in these statements which included a more satisfactory "break down" of costs attaching to the revenues. Utilities, distillers, food, mining and oil companies were among those giving such information.

Statistical vs. Financial Reporting

There seems to be a disinclination on the part of Canadian companies to give any information as to sales, costs attaching to sales, employment costs, or administrative and distributive charges. This is probably understandable in some cases where disclosure might give confidential and valuable information to competitors. What is not so easy to perceive is the kind of thinking that will permit the most fragmentary information to be exhibited in the published profit and loss account and give essential information as to sales, costs of materials, etc., employment costs, etc., by way of statistical data, through which any intelligent person, by converting the statistical data, could arrive at a reasonable approximation of the actual figures.

The supplying of this supplementary information is done for the purpose of stimulating good public and employee relations. In the majority of cases it is most useful and valuable information, accurately charted and most attractively presented. If this can be done for employee relations, which I grant is one of

the most important considerations of management, surely it can be done in the cause of more informative financial reporting. One is inclined to speculate that there must be a lack of co-ordination between the financial group and the public relations group in large industrial organizations. One example of this is of a large company which reported a net profit for the year carried to earned surplus $20,000,000 and which, on the published profit and loss statement, was reported in four or five lines — Operating income less depreciation, other income, other dividends, provision for taxes – Net profit; whereas, the public relations group gave in another section of the same report the Sales, cost of raw materials, cost of manufacturing, freight, cost of distributing and selling, taxes paid, total cost, operating profit. If such information may be given out by one group surely it can be published for the information of those who are interested in the interpretation of financial reports.

Legal Requirements of Section 113

The legal requirement of section 113 of the Companies Act is, in my opinion, partly responsible for the development of this kind of financial reporting. Furthermore, the provision that, "the said statement of income and expenditure shall show separately net operating profit before depreciation and depletion, interest on funded indebtedness, etc.,[10] tends towards a trustful acceptance of the theory of the "ranking of costs" and lends encouragement to those who are inclined to treat costs as recoverable through revenues in some sort of preferential order. In the majority of statements which I have examined the statement of profit and loss commences with an item "Profit from operations before providing for the undernoted items $ xxx." This is followed by a progressive series of additions and deductions showing intermediate gradations of profit given different appellations until the final figure is reached. At this point there is a considerable degree of agreement — Canadians like the term "net profit for year" and in this way are in agreement with Mr. George O. May, who has expressed on various occasions the view that the term "profit" with its converse "loss" was preferable to "income" but he says "usage is against him".

In order to avoid "additions and deductions" some companies have grouped together all of the revenue items and all of the deductions, subtracting one subtotal from the other, leaving a balance "Net profit before provision for Income Taxes".

In other cases where the "step – add and deduct" type of statement was used, no attempt was made to indicate what certain sub-totals were intended to represent and in other cases even the "end" figure was left anonymous and obscure.

It is known to practising Chartered Accountants, and to their clients, that published statements of profit and loss are, in most cases, condensations of the auditors' presentations. Unfortunately, these published statements of profit and loss are put into the hands of those whom Mr. Bailey has designated "Non-insiders", therefore such statements should be designed so as to serve a useful and valuable purpose to this group as well as to the "insiders" who are "in the know".

Professor Paton in his timely article "The Accountant and Private Enterprise" made some remarks with reference to the type of statement under discussion which might be worth repeating at this point.

> "The longstanding practice of striking a balance in the income statement labelled 'gross profit' after deducting the so-called 'merchandise cost' or 'manufacturing cost' is a glaring example of unsound and misleading

[10]The Dominion Companies Act, *op. cit.*

arrangement of data. I have been pointing out the questionable character of such presentations for thirty years and am glad to see recently some trend toward the abandonment of this practice in corporate reports to stockholders. In the nature of the case, no income or profit to the business can emerge until all charges have been deducted. There is no objection to classifying and detailing costs in the income statement, but *seriatim* deduction from revenue, and prominent display of several 'profit' figures, is not based on valid relationships and is definitely misleading. This practice has undoubtedly aided and abetted propagandists interested in picturing corporate profits as much larger than they really are. It is high time that accountants put their house in order at this point."[11]

Having by this time raised a hornet's nest around my academic ears, let me proceed to a discussion of some of the theoretical aspects of income determination and of the profit and loss statement.

A discussion of this subject at this time is appropriate, particularly so since the issuance of Bulletin No. 32 by the American Institute of Accountants.[12] It is our good fortune to have with us Mr. Bailey, the Chairman of the American Institute's Committee on Reseach — he is the expert and the philosopher in this field.

At this point I am reminded of a theological student who thought he had been given a "tip-off" about the examinations through which he gave a great deal of study to the minor and the major prophets. On the day of the examination, on receiving the paper, he was greatly disturbed to read the leading question, which asked for a critical discussion of the philosophy and life of St. Paul. Taken aback, my theological friend wrote—"Far be it from me to criticize the philosophy of so great a man as St. Paul; but the major and the minor prophets are as follows"!

Accountants are greatly indebted to Mr. Bailey for his article "The Increasing Significance of the Income Statement" which analyses the New Research Bulletin "Income and Earned Surplus", along with Bulletins 23 to 31 to show the underlying trend towards narrowing areas of permissible practice in presentation of income.[13]

The publication of this Bulletin has been responsible for the appearance of several splendid articles on income determination, some upholding and others disagreeing with the recommendations contained in the Bulletin.

Problem of Income Determination

The problem of income determination is one which greatly concerns Chartered Accountants. There is little argument about the determination of the profit or loss over the lifetime of the enterprise; the difficulty arises when we begin to divide the stream of revenues and costs into "accounting" periods such as the "quarter" or the "year" for the purpose of determining "periodic" income. This determination of income involves complex accounting procedures and the application of well established principles of accounting, I am using principle in the sense of "a hypothesis so adequately tested by observation and/or experiment that it may be intelligently put forward as a guide to action, or as a means of understanding."[14]

[11] William A. Paton, Ph.D., C.P.A., "The Accountant and Private Enterprise" *The Journal of Accountancy*, January 1948, pp. 44-58.

[12] Accounting Research Bulletins, Committee on Accounting Procedure, American Institute of Accountants, New York.

[13] *ibid; — op. cit.*, 7.

[14] Leonard D. White et al. *Frontiers of Public Administration.* (Chicago University Press 1936) p. 21.

There are two approaches to the problem of income measurement:

(a) The "balance sheet approach" which involves evaluation of residual values of the specialized assets which are to be carried forward, or, as Professor Smails puts it in his excellent new edition of *Accounting Principles and Practice*:

"Annual income is measured as the excess of the value of all assets (Net of liabilities) owned by the business at the end of the year, over the value of all assets (Net of liabilities) owned at the beginning of the year, making allowance for any assets which the owner may have withdrawn or introduced during the year."[15]

(b) The "Income approach" which attempts to match the appropriate costs against revenues. By this method of approach the expired costs are entered in the income statement and the residual values of the assets represent the costs which are carried forward in the balance sheet to be absorbed in future accounting periods.

The method of approach to income determination will condition the result and it would be wise for us to fully recognize the value of the balance sheet as a check or control in income accounting. However, the matching of costs against relevant revenues should lead to the emphasis of current costs in the profit and loss account and a more accurate division of the stream of costs incurred between the present and future.

A "Round Table" on income determination is particularly opportune at this period of our social and economic history when the concept of business income itself is under scrutiny. The general conception of income is one of gain or yield and that business income is normally a balance that remains after appropriate deductions have been made from revenues to cover what has been given out or absorbed.

George May says,

"In measuring income so conceived there can be no axioms or self evident truths, for business income is an intellectual concept which is not unique, but may be, and indeed *is* given different meanings at different times, in different countries or for different purposes."[16]

Any concept of income must include a unit of measurement, an understanding as to the time when income is deemed to emerge, a matching of direct and indirect costs against relevant revenues, recognition of profits only as they are realized, recognition of losses in the period of the occurrence or of that in which they come to notice, and the concept of the indefinitely long life of the concern.

Adherence to Cost Principle

The more complex procedures are associated with absorbing the cost of service life of long-lived assets, the flow of costs of raw materials and services into the finished product, the estimation of "Cost of goods sold".

Many of the accounting problems of today stem from the adherence of accounting to the cost principle and to the allocation of costs to periods. These difficulties are accentuated and magnified by the unprecedented inflationary rise in prices and the swelling of the dollar sales volume to previously unknown levels. This increase in physical volume and in prices is reflected in the dollar profits of companies and is giving rise to serious concern on the part of management and business executives.

[15] R. G. H. Smails, Accounting Principles and Practice, (Toronto, The Ryerson Press, 1948) p. 408.

[16] George O. May, "Postulates of Income Accounting", *The Journal of Accountancy*, August 1948, pp. 107-118.

We are limited by the fact that accounting techniques fail to reflect changes in purchasing power. In the income statement revenues such as sales and costs, wages and other such items are stated in terms of current dollars, while items such as depreciation, and in some cases materials, depending upon inventory policy are stated in terms of dollars of a different purchasing power. It is the general practice to compute charges for exhaustion of property on the basis of cost expressed in dollars without regard to changes in either the general purchasing power of the dollar or the current price of similar property.

In a letter headed "Some facts relating to Canadian Corporation Profits" dated 30th July, 1948, the Canadian Manufacturers' Association quotes the following statement from the June, 1948, monthly letter of the National City Bank of New York.

> "The increase in replacement costs over original costs of plant and equipment creates not only the problem of providing the actual funds to finance such replacements as they become necessary, but also accounting problems in the preparation of financial statements to reflect this advance. Since annual depreciation charges to amortize the value of fixed assets over their estimated useful life are based according to long established and almost universally accepted practice, upon original costs, they are in most cases at a rate which is far below that needed to build or purchase similar assets today. This inadequacy of depreciation currently charged against earnings causes in a sense another Statement of Net income. What happens is that the business is selling out piece meal its low cost productive assets and taking the profit into operating income."[17]

[17]Canadian Manufacturers' Association; "Some facts relating to Canadian Corporate Profits", July 30, 1948. Toronto.

Anticipatory and Precautionary Reserves

Canadian businessmen are deeply concerned about the matter, so much concerned, that they are resorting to the practice of the creation of anticipatory and precautionary reserves. Such reserves are provided as a cushion against the shock of a sudden decline in the level of prices or for the replacement of plant at prices far in excess of the original cost of the asset to be replaced, or for other purposes generally designated as contingencies.

Such reserves are generally created as a result of managerial or fiscal policy. Unfortunately, however, there are wide variations in the methods by which these reserves are reflected in the published accounts and indicate a disinclination, and I quote Earle C. King, "on the part of management to accept as realistic profits determined in accordance with accepted accounting principles which contemplate adherence to cost and the matching of expired costs against revenues".[18]

It is noticeable that such reserves are as likely to be found in the income statement appearing before the determination of net profit or immediately after the net profit figure before transfer of the balance of net profit to earned surplus as they are to be found in earned surplus. This method of treatment tends to obscure the net income figure and violates the basic principle which requires the exclusion of appropriations from the determination of net income. It also opens the door to a misstatement of the amount of earnings per share and gives credence to the belief held by a large and articulate group that profits are too high and that they are being hidden in this manner.

[18]Earle C. King "New Trends in Published Reports" *The Canadian Chartered Accountant*, August 1948.

For purposes of this discussion I have selected examples of provisions found in the published statements which I have examined.

PROVISION FOR RESERVE FOR CONTINGENCIES

			1946
1.	Profit from operations for year before providing for depreciation and income and excess profits taxes		$ 5,500,000
	Less: Special provision added to reserve for contingencies		500,000
			$ 5,000,000
	Deduct: Provision for depreciation	$ 680,000	
	Provision for income and excess profits taxes	2,700,000	
			3,380,000
	Balance of profits for the year carried to Earned Surplus		1,620,000

			1947
2.	Deducted before net profit figure shown:		
	Transfer to reserve for contingencies		$ 100,000
3.	Included with deductions before statement of Net Profit figure:		
	Provisions for losses on investment in companies engaged in exploration activities:		
	Subsidiary company (not consolidated)		$ 1,300,000
	Associated companies		3,600,000
4.	Reserve for Investments		$ 4,100,000
	Note: Reserve which management feels should prove adequate aggregating $7,500,000 including $4,100,000 provided in the year 1947 are carried against combined investments and advances.		
5.	Operating profit		$63,500,000
	Other income		1,100,000
			$64,600,000
	Provision for depletion	$7,600,000	
	Retirement system	3,000,000	
	Contingencies	3,000,000	
			13,600,000
	Profit before taxes		$51,000,000
	Provision for taxes		17,500,000
	Net profit carried to surplus		$33,500,000

The American Institute has made a series of pronouncements with respect to precautionary and arbitrary reserves. Bulletin No. 28—July, 1947, in part states:

"The Committee is therefore of the opinion that general contingency reserves, such as those created:—

(a) for general undetermined contingencies, or

(b) for a wide variety of indefinite possible future losses, or

(c) without any specific purpose reasonably related to the operations for the current period, or

(d) in amounts not determined on the basis of any reasonable estimate of costs or losses

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income."[19]

In the cases cited provisions for contingencies were made before determination of net income.

In Accounting Research Bulletin No. 31 issued by the American Institute Committee in October, 1947, the following pronouncement was made:

"The Committee is therefore of the opinion that inventory reserves, such as those created:

(a) for possible future inventory losses on inventories not on hand or contracted for, or

(b) without due regard to any specific loss reasonably related to the operations of the current period, or

(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income and that they should not be used to relieve the income account of any year."[20]

The following examples indicate the trend in Canadian practice. In some cases further information would be required to determine the nature of the provision, while in other cases the description of the item discloses the arbitrary nature of the provision.

PROVISION FOR INVENTORY RESERVE

1. Net profit for year			$ 1,500,000
Deduct for possible inventory losses			200,000
Total carried to statement of Consolidated surplus			$ 1,300,000
2. Net profit before providing for inventory reserve			$ 1,700,000
Reserve for decline in inventory values			500,000
Consolidated profit carried to Earned Surplus			$ 1,200,000
3. Profit from operations, etc			$ 994,000
Provision for depreciation		$ 113,000	
Interest on debentures		15,000	
Increase in reserve against future decline in inventory values:			
Provided under terms of the Excess Profits Tax Act	$98,000		
Additional provision	50,000		
		148,000	
Provision for income and Excess Profits Taxes		382,000	
			658,000
			$ 236,000
4. Profit before taxes on income and provision against the contingency of decline in inventory values			$14,150,000
Provision for taxes		$6,150,000	
Provision against contingency of decline in inventory values		2,000,000	
			8,150,000
Net profit for year after above provision			$ 6,000,000

[19] *op cit.*

[20] *op cit.*

5. Income from operations etc., after charging all expenses including depreciation and providing a reserve against future loss in inventory values		$ 9,700,000
6. Profit from operations for the year ended 31st December after applying $1,000,000 to the reduction of inventory values and before deducting undernoted charges		$ 6,500,000
7. Balance before Bond interest, depn. and Income and Excess Profits Taxes		$25,000,000
Deduct: Interest on first mortgage bonds—net	$1,200,000	
Provision for depreciation	4,100,000	
Provision for future decline in inventories	500,000	
Provision for income and Excess Profits Taxes	9,600,000	
		15,400,000
		$ 9,600,000
Add: Profit from sale of securities		230,000
Balance transferred to Earned Surplus		$ 9,830,000

With respect to provision for depreciation, Bulletin No. 33 published by the American Institute Committee on Accounting procedure in December, 1947, contained the following:

> "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The Committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time. The Committee disapproves immediate write downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal cost occasioned by current price levels."[21]

I have not much to offer by way of example of "write downs" of the nature of those referred to above as I have not been able to make a study of the charges for depreciation in relationship to the unexpired service life of the assets being depreciated.

The following examples are included as an indication that in some cases something more than provision for normal depreciation is being included in the charges.

ADDITIONAL PROVISION FOR DEPRECIATION

1. Added to earnings immediately preceding net profit figure:		
Net profit on investments sold	$155,000	
Less: Appropriation to increase depreciation on buildings and machinery	100,000	
		$55,000

2. Gross profit after providing for manufacturing, delivery, selling and administrative expenses including depreciation of $37,000 (Normal, accelerated and double).

3. No designation given totals in a reducing balance form of statement. Immediately after provision for taxes appears an appropriation for extensions and improvements $250,000. Then follows the Earned

[21] *Op. cit.*

Surplus Statement implying that the figure just preceding is the Net profit for the year.

4. **"Transfer to reserve for depreciation of amount approved by the Board of Directors $250,000."**

It is presumed that this figure includes normal depreciation and a further amount set aside by the Board of Directors.

Relation of Dollar Costs to Current Dollar Income

Two other suggestions have been put forward in an attempt to relate dollar costs more specifically to current dollar income

(a) A restatement of the costs of capital assets in the books in terms of present day costs.

(b) The use of index numbers to convert the charges for such items as depreciation to terms of present day dollars.

In view of Bulletin No. 33 of the American Institute, accountants are not likely to give much consideration to the appraisal theory until prices taper off to what might be considered the New Post-War II level. It should be observed that the price level has been rising continuously and there is no present indication of a recession. While the price level will not recede to the 1939 level, history indicates that it does recede to a somewhat lower level than the highest peak reached during a phenomenal rise after a period of war.

This situation leaves the Chartered Accountant in a precarious position. Professionally, he does not like appraisals, he is still mindful of the fantastic appraisals of the twenties and the equally extravagant write-downs of the thirties. In the meantime, Bulletin No. 33 of the American Institute suggests that where there are gross discrepencies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels. Previously the American Institute's Committee had indicated that it was preferable to create such reserves through an appropriation of surplus.

The use of index numbers would complicate the situation seriously if they were applied to residual values in the balance sheet, as the index numbers would doubtless change from year to year and would make comparison difficult. Application of index numbers to the charges for such items as are stated in dollars of a different price level from current costs would not complicate the situation unduly. It would be necessary, of course, to ascertain the index number applicable to the year in which such assets were bought and use the index number applicable to that year when making the calculations. The difference between the calculation made on original cost and that made by the use of index number would have to be shown as a segregation of surplus. I see little advantage to be gained from the use of this method as the majority of accountants could make a reasonably accurate estimate of the difference involved which could be set up as a reservation of surplus.

Finally, I should like to make a brief reference to Bulletin No. 32 published in January of this year by the American Institute's Committee on Accounting Research.[22]

The publication of this Bulletin has been responsible for the expression of a difference of opinion with respect to income reporting between the two major American accounting bodies which are

[22] *Op. cit.*

interested in the attainment of high standards of accounting practice and accounting education. The American Institute of Accountants is the professional body comparable with our Dominion Association and the American Accounting Association is composed for the most part of professional accountants who have academic status.

This controversy centres around the "current operating performance" type of income statement recommended by the American Institute and the "all inclusive" type of statement favored by the American Association.

The view of the Institute is that the income statement must be as significant as possible of the operations of the business for the year, presenting as "sharp" an income figure as possible, whereas the Association continues to take the position that it is more important to have all items reach the surplus account through the income statement, than to have a "sharp" determination of income for the year.

The institute would omit from the income statement such items as:

(a) Material charges or credits specifically related to operations of prior years.

(b) Material charges or credits resulting from unusual sale of assets not acquired for resale.

(c) Material losses occasioned by wars, riots, earthquakes, catastrophes, etc. not a recurrent hazard of the business.

(d) The write-off of material amount of intangibles.

(e) Write-off of material amounts of unamortized bond discount or premium at the time of retirement of or refunding of the debt before maturity.

Such items it is recommended should be shown in Surplus or, if preferable, in a second section of the income statement after the determination of the net income for the year, in which case the final figure at the end of the first section should be designated "Net Income for the year" and the final figure of the second section called "Balance transferred to Surplus".

The "All inclusive group" insist that the final figure in the second section should be denominated "Net income for the year" which reminds me of the motto of a famous Canadian regiment which won its spurs on these plains during the Riel Rebellion "Hosti Acie Nominati".

Critics of the proposal imply that the recommendation will open the way for questionable adjustments through surplus which will destroy the value of the net income figure especially as a measurement of earnings on invested capital.

Canadians seem to have taken a different approach to this question. We imply that the income of the period shall disclose any material respects in which it includes extraneous or non-recurring transactions of an exceptional nature, but, "canny-like" we do not say in which statement they shall appear. My own impression is that in the recent past there has been a tendency to include as much as possible in the income account. However, this may not reflect secular trend but may be the result of economic conditions.

In conclusion let me express the hope that you will discuss these matters frankly. I have not attempted to propose a solution to the problem of:

(a) A meaningful terminology or vocabulary.

(b) Form and content.

(c) Statistical data vs. financial reporting.

(d) Legal requirements of section 113.

(e) Adherence to the cost principle.

(f) Anticipatory and precautionary reserves.

(g) A realistic net profit figure.

What's the Matter With Our Balance Sheets?

By N. R. Moran, B. Com., C.A.

Some suggestions for clarifying the balance sheet

OF ALL statements prepared by accountants the balance sheet seems to be the least understood. Despite this lack of understanding accountants have continued to prepare balance sheets in much the same form and using much the same terms over a period of years. To them the fault lay not with the balance sheet but with the persons who could not understand it. These misunderstandings, though, are so universal and have extended over such a period of time that it seems that at least some of the fault must be with the balance sheet. All of the people surely can't be wrong all of the time.

Factors Causing Misunderstanding

It seems to me that there are three main factors which account for most of the misunderstanding:

(1) The title
(2) The terminology
(3) The form

The titles "Profit and Loss," "Application of Funds," "Statement of Surplus" give an idea of what is to follow. The title "Balance Sheet" merely indicates that we are going to produce a sheet which balances. I once heard the remark, "It balances . . . So what?" If the intention is to produce a statement of assets and liabilities why not say so? The titles "Statement of Assets and Liabilities" and "Statement of Financial Condition" are both more descriptive titles, albeit somewhat clumsier, than "Balance Sheet".

A discussion of terminology leads into a more difficult field but even here three words seem to account for the greater part of the misunderstanding. These are: *"reserve, capital, surplus"*.

It also seems that the basic reason underlying the misunderstanding of these words is the same for all three, namely, that they are used in a different manner by the accountant than by the rest of the world.

"Reserve"

In common speech the word "reserve" means reserve supply, something extra. In accounting terminology it means a reduction, either of some specific asset as where a "reserve for bad debts" appears, or a reduction of available surplus, as where a "reserve for contingencies" appears. To make matters even more confusing accountants have also used the word to mean an estimated liability as where "reserve for Income Tax" appears. This one word alone has in my opinion outranked all others in confusing readers of balance sheets. How could they understand it, when it had

three different meanings and appeared on both sides of the balance sheet?

To the layman the word "capital" means the total assets employed. That is, "capital" is the actual tangible assets. The accountant, however, uses the word to mean the proprietorship equity in assets. If this seems like a minor difference, consider that it shifts "capital" from one side of the balance sheet to the other.

"Surplus"

As to the word "surplus" the difference between common and accounting meaning is not so marked. The chief point of difference here is that persons other than accountants think of "surplus" as "cash surplus". Then when several types of "surplus" like "earned surplus", "distributable surplus", and "capital surplus", appear, the reader is unable to determine what the accountant means because he has enough information to show him that the accountant is not using the word the way he would use it but not enough information to tell him just how it is being used.

If the words "reserve", "capital", and "surplus" were dropped altogether from published statements it would clear away the biggest of the stumbling blocks relating to terminology. These are all very useful words to the accountant in communicating his thoughts to other accountants and I do not suggest that they be abolished from his vocabulary, but I do suggest that they not be used in communicating to the public.

Suggested Substitutions

For the word "reserve" the word "provision" is even now coming into more general use where the reserve represents an actual provision as for bad debts or depreciation. The term "estimated liability" is self-explanatory. The words "earnings reserved for" could be used where the reserve is one created by a charge to surplus and constitutes merely a setting aside of otherwise free surplus.

Mr. Moran is a graduate in Commerce of the University of Alberta (1930) and a member of the Alberta Institute of Chartered Accountants (1936). Forced to give up the practice of accountancy because of eye trouble, Mr. Moran is now devoting the few hours per day which his eyes allow to writing. One of his objects is to increase the the public understanding of what the accountant performs and what financial statements are all about.

For the word "capital" the heading "shareholders' Equity" followed by the sub-headings "Shares" and "Profits Reinvested" should clarify the picture. In the case of an unincorporated enterprise the term "Proprietorship" or "Partners' Equities" might be used.

For the word "surplus" the more explanatory term "profits reinvested" could be substituted. This would get away from any idea of the surplus being in cash as the word "reinvested" carries the opposite implication, i.e. that the cash surplus has been invested in something and is no longer in the form of cash.

I realize that all of these suggested terms designating "capital" and "surplus" are clumsier than the terms currently in use. However, the misconceptions concerning these two words are so firmly rooted that I believe it is easier to find new terms than to explain the old. As understanding increased we might later be able to return to the original terms.

I think the second place in the race for top honors in the Department of Confusion, first place having been already awarded to the word "reserve", is

the form in which the balance sheet is presented. The chief difficulty of course is that the proprietorship equity appears on the liabilities side. In my experience, this is a puzzler to exactly one hundred per cent of the untrained readers. Clarity has been sacrificed to the mechanics of making the balance sheet balance.

Could we not kill two birds with one stone by calling it a "Statement of Assets and Liabilities?" First, the reader knows what he is looking at, and second, we have freed ourselves from the necessity of making the sheet balance. Now the figures can be set out in the more logical order of listing the assets, deducting the liabilities, and ending up with the proprietorship.

Where a public accountant in his capacity as statutory auditor prepares a balance sheet (yes I know that technically it is the directors' balance sheet and he merely audits it but you know who, in ninety-nine cases out of a hundred, actually prepares it) he is preparing it not for management who theoretically can read balance sheets, but for the shareholders. It should be his first consideration to give them something they can understand, regardless of accounting conventions as to either terminology or form.

Understanding Balance Sheets

I believe that part of the trouble laymen have in understanding balance sheets is due to the fact that the statement of profit and loss and the balance sheet are looked upon as two separate and entirely independent statements. Further, there is nothing on either statement to show where the profit has gone, except the statement of surplus, which traces it into the surplus account. This merely adds to the confusion by bringing up another question, "Where is the Surplus?" There is nothing on the statements to answer that question either so it is not surprising that most people get stalled at about that point in the reasoning.

It seems to me that it would make the picture a little clearer if a statement of application of funds were presented as part of the regular set of statements. It ties up with the statement of profit and loss by showing "Funds provided by profits," and it traces all funds into the asset side of the balance sheet. That is, in the tie-up of the balance sheet with the statement of profit and loss the profit is followed into the surplus account, which is merely a book account, an abstraction, where is it? But in the tie up of the statement of application of funds with the statement of profit and loss and the balance sheet, the profits are traced to their ultimate resting place of increasing an asset or diminishing a liability or being drawn out. If the preparation of a statement of application of funds will increase the public understanding of accounts it is a step worth the effort. It is not a difficult nor time-consuming statement to prepare.

Besides its value as a clarifying statement it is a very useful statement in itself. The next question after "How much did I make?" is invariably "Where did it go?"

I honestly believe that one reason why more clients have not insisted in past years on this statement being prepared for them is that they were not aware that the auditor could prepare it!

I rather like the way one accountant prepares a statement of application of funds. Instead of showing, say, "Increase in Fixed Assets" then "Increase in Working Capital" (including cash on hand) he shows "Increase in Fixed Assets" then "Increase in Working Capital" (exclusive of cash on hand) and shows the increase or decrease in cash as the last figure on the statement. This distorts the working capital increase or

decrease but nevertheless ties up the statement of application of funds with the funds. The client now has a statement which ties in with the statement of profit and loss "Funds provided by profits" and which also ties in with the opening and closing cash balances, "Funds provided by decrease of cash on hand" or "Funds applied to increase cash on hand".

There is the further possibility that by following this procedure not only would each separate statement, balance sheet, profit and loss, and application of funds, be better understood but it might even dawn on some of the readers that the statements are inter-related. Once that is established in his mind he has jumped the first hurdle toward understanding accounts.

OBITUARIES

The Late Leon Hurtubise

The Institute of Chartered Accountants of Quebec announces with deep regret the death of Léon Hurtubise in his seventy-first year.

Mr. Hurtubise was a former member of the Corporation of Public Accountants of the Province of Quebec, and a partner in the firm of Hurtubise and Richard. Born in Montreal, Mr. Hurtubise was educated at St. Mary's College and was well known in business circles for over forty years.

The members of the Institute extend their sincere sympathy to his widow and family.

The Late Thomas Howard Ingram

The Institute of Chartered Accountants of British Columbia announces with deep regret the passing of Thomas Howard Ingram in his seventy-eighth year.

The late Mr. Ingram was born in England and came to Canada as a youth in the year 1888. He received a business education at Stratford, Ontario and subsequently had a varied experience in accounting with commercial and financial businesses in Ontario and Alberta. He moved to Vancouver in the year 1903 and became interested in a financial company of which he ultimately became president and of which he was manager of the London, England office during the years 1910 to 1914.

The late Mr. Ingram was admitted a member of the Institute of Chartered Accountants of British Columbia in the year 1922 and practised his profession in Vancouver until he recently retired and moved to Langley Prairie. His tragic passing is mourned by his many friends.

To his daughter, the members of the Institute extend their sincere sympathy.

The Late Marcel B. Morency

The Institute of Chartered Accountants of Quebec reports with deep regret the death of Marcel B. Morency, in his forty-seventh year.

Born in Sherbrooke in 1901, Mr. Morency was educated at Ste-Marie College and l'Assomption College, and commenced to practise in 1934. At the time of his death he was senior partner in the firm of Morency, Gagnon & Cie. He was a past president of the Montreal Branch of the General Accountants Association, and was for some years in the employ of the Department of National Revenue.

To his widow and family the members of the Institute extend their sincere sympathy.

Some Remediable Defects In Published Accounts

By Cecil A. Ellis, C.A., A.S.A.A.
(*Chief Accountant of the Provincial Electricity Board in Montreal*)

An argument for fuller disclosure of matters concerning inventory values.

TIMELY consideration is being given by the American Institute of Accountants' committee on procedure, to essential disclosures in published financial statements. The progress of this enlightened step and the recommendations of the committee will interest accountants everywhere. In the meantime it is likely that Canadian, British and other accountants outside the U.S.A. will also be considering means by which financial statements may better serve management, investors and the general public.

Some remediable defects in published accounts lie in the nondisclosure of certain essential information concerning values and volumes of inventories. Such failure, probably more often unintended than purposed, frequently induces faulty conclusions, which, in turn, cause highly undesirable effects. Before proceeding to consider such effects, recognition is due to Mr. Kenneth MacNeal, C.P.A., who in his book entitled, "Truth in Accounting" (published during 1939) demonstrated some far-reaching ills that can result from misconceptions of inventory values as published in financial statements. Although one may differ from Mr. MacNeal's contentions that market values should always be used for inventories, even when above "cost", some examples which he gives showing how the "lower of cost or market" rule can induce misleading conclusions, should not be ignored. The root of our subject touches methods of determining inventory values.

Methods of Valuation

Leaving aside for the moment the refinements of FIFO, LIFO, Average Price, and other methods for determining "costs" of inventories, the well known valuation principle for accounting purposes calls, of course, for the use of "cost" values when they are below "market", and the application of "market" when it is less than "cost". This "lower of cost or market" rule is followed, not merely to conform to the ultra conservatism of timid accountants, but, as we all know, in order to avoid anticipation of profits when fluctuating market prices exceed cost, and to provide against contingent losses whenever the signals of lower market prices indicate possible inability to recover "costs" at normal profit margins. With every desire to approach business realistically, no auditor can safely ignore that rule. To do so would be to expose his client and the investing public to unjustifiable and evident risks.

Nevertheless, the "lower of cost or market" rule is capable of being exploited for private financial gain by company officers and other favoured "insiders" who have exclusive information as to relations between inventory values and inventory quantities. It is because the interests of good business can best be served by reasonable disclosures of all pertinent financial information, that the deliberations of the American Institute of Accountants, and other interested persons, can produce valuable results.

Practical Examples

So as to demonstrate something of the manner in which, if not amplified, the accepted valuation rule can induce misleading conclusions, let us consider the cases of two affiliated companies in circumstances which are by no means exaggerated.

Company "A" and its affiliated Company "B" commence at the same time the business of manufacturing, let us say, copper sheeting. Each has a similar sales territory; from its subscribed capital, each sets aside $1,000,000 for the purchase of raw materials (copper), which it prices on the FIFO basis. Although each company is separately managed, both are controlled by a holding company "X". The shares of both "A" and "B" are traded on national stock exchanges.

Now, Company "A", managed in a venturesome way, purchases all its annual copper requirements at the commencement of each year at the price then prevailing; "B", more conservatively buys its copper from month to month, and at the average price for each year.

Copper prices are as follows (per pound):—

	Opening	Average	Closing
First year (rising prices)	10c.	14c.	15c.
Second year (rising prices)	15c.	20c.	25c.
Third year (falling prices)	25c.	10c.	8c.

Respective copper purchases are:

Company "A"				
First year	10,000,000 pounds	at 10c.	for	$1,000,000
Second year	6,666,667 pounds	at 15c.	for	$1,000,000
Third year	4,000,000 pounds	at 25c.	for	$1,000,000
Company "B"				
First year	7,142,867 pounds	at 14c.	for	$1,000,000
Second year	5,000,000 pounds	at 20c.	for	$1,000,000
Third year	10,000,000 pounds	at 10c.	for	$1,000,000

The annual consumption of copper is 6,000,000 pounds in each case; the physical volume of manufacture for sales, evenly spread throughout each year, is the same in each case. However, price fluctuations from year to year take place, and monetary sales are, for each company:

First year	$2,200,000	
Second year	$2,750,000	(25% up)
Third year	$2,475,000	(10% down)

Labour and all other charges (including depreciation of plant, etc.) are $1,400,000 annually for each company.

In all the foregoing, entirely reasonable circumstances, the accounts of the companies would show the following results:

		First year	Second year
Company "A"	$200,000 profit	$650,000 profit	$411,666 loss (a)
Company "B"	40,000 loss	218,574 profit	377,854 profit (b)

(a) after reducing inventory value from "cost" to "market" by $453,333.

(b) after reducing inventory value from "cost" to "market" by $ 82,89.

The respective closing accepted inventory values would be:

At end of	Company "A"		Company "B"	
First year (at "cost")	(4,000,000 lbs.)	$400,000	(1,142,867 lbs.)	$160,000.
Second year (at "cost")	(4,666,667 lbs.)	$700,000	(142,867 lbs.)	$ 28,574.
Third Year (at "market")	(2,666,667 lbs.)	$213,334	(4,142,867 lbs.)	$331,428.

Volume and Price Disparities

The respective financial statements as they would be published would naturally reflect the fact that because of its bolder purchasing policy, Company "A" was the more successful when copper prices were rising; and that when copper prices were falling, the more conservative policy of Company "B" produced the greater profit. But, what both statements would fail to disclose is the highly important fact that as between the two companies there was a far greater disparity between physical quantities of inventories carried than could be gathered from comparison of the respective published *monetary values*. Persons better informed than the outside shareholders would, however, have means of knowing that, taking Company "B" as a yardstick, Company "A" carried:

At close of	Physical Volume	Valued at only
First year	350%	250%
Second year	3266%	2450%

(Because market prices ruled in each case at the close of the third year, the disparity then disappeared.)

The above comparisons show that at the close of the first year the physical inventory of Company "A" was 40% greater than is indicated by comparison of financial values. More significant is the fact that at the close of the second year, Company "A", comparatively, was exposed by 33% more than the relative financial statements indicated, to the price collapse which ensued; and that this further exposure aggravated its comparatively bad results for the third year to the extent of $116,667 upon 1,666,667 pounds of copper.

In the form in which they would normally be published, the financial statements for the first two years would cause Company "A" shareholders much satisfaction with their choice of investment; and the Company "A" shares would reasonably sell for much higher prices than those of Company "B" at the commencement of the third year. During the third year, however, discerning investors would note falling copper prices, and draw such conclusions as they could from the published statements as to the vulnerability of Company "A" to that decline. When the results of the third year become published, however, those investors would be rudely awakened to the fact that because its opening inventory was 33% higher than they had calculated, Company "A" showed much worse results than they had expected. The resulting shock would create much avoidable discontent concerning the Company "A" shares. To an appreciable extent such a condition would result from a remediable defect in the published accounts of the second year.

Also, during the third year, the officers of Company "A", and other favoured "insiders", armed with the facts concerning the inventory *quantities* carried from the second year would be able, if they so desired, to enrich themselves by selling that company's shares and buying those of "B"; this at the expense of "outsiders", who have equal rights to share in pertinent knowledge concerning the affairs of the two companies. Here lies another consequence of a defect in published accounts.

An additional defect lies in the cus-

tomary nondisclosure of the precise method by which inventory "costs" are determined, be it FIFO, LIFO, Average Price or any other method. Had LIFO been used by the companies instead of FIFO, our examples would have shown a shifting of profit from the second to the third year to the extent of $200,000 by reason of a corresponding lessened inventory "write down" in the case of Company "A", and to the extent of $8,574 in that of the less affected Company "B". Advance knowledge of the pricing method used by the companies would have enabled any interested shareholder or investor to calculate better the prospects for the companies during the third year, or to obtain calculations from those competent to judge as to the varying effects of the respective methods.

Other examples of defects in published financial statements could be mentioned, but they are outside the scope of this present discussion.

Remedial Measures

Confining ourselves to inventories, we find that if it were possible to value all inventories upon a common base (such as at "market"), some of the aforedescribed objections would be eliminated. Seeing, however, that market prices cannot be used when they exceed cost, and that no other common price measure can be found, remedy for the defects as to inventory quantities in published accounts must be sought in other directions.

Obviously inventory quantities cannot be published within the space available, but the search for a remedy quickly brings realization of the fact that publication of fuller information would meet the need.

Every affected financial statement could and should show both the "cost" *and* the "market" value of included inventories; such dual particulars are customarily displayed whenever investment portfolios are carried, and there is every good reason why they should be similarly displayed for inventories. Every affected financial statement should also show the precise pricing method employed in determining inventory "cost", be it FIFO, LIFO, Average Price or any other method.

From such fuller information, to which they are fully entitled, unprivileged "outside" shareholders, investors, lenders and members of the general public would be better enabled than at present to estimate inventory positions and so to draw more reliable financial conclusions when comparing accounts of businesses within the same lines of industry. Such fuller information, which can so easily be published, would help to protect all concerned against faulty conclusions and their costly effects; it would place all shareholders, investors, lenders and other interested parties on a fair common basis; it would assist in making business more healthy.

Publication of the desired additional information could perhaps be enforced in Canada by a short extension of Section 112 (2d) of the Dominion *Companies' Act*, which at present requires statements of the bases of inventory values. The present custom of reporting that the "lower of cost or market' 'is used, seems to fall far short of what is needed.

Conclusion

It is clear that in their present form, published financial statements lack certain essential information concerning inventories. Equally clear is the fact that such lack leaves the way open to faulty conclusions from the published statements, and to unfair exploitation of those conclusions. When disclosure of the essential information now indicated becomes obligatory, published financial statements will better perform their function to serve management, investors, lenders and the general public.

LETTERS TO THE EDITOR

Success in Examinations

Toronto, Oct. 13, 1948

Sir: I have just concluded the article "Preparing for Examinations" in your September issue. Adequate preparation, particularly for the working of papers under examination conditions, is naturally very important, and adds to the candidate's confidence.

However, to my mind, the crux of the matter is the reaction of the student when confronted with examination conditions, and this is possibly one criticism of the present method of testing a candidate's knowledge. Consequently, one candidate with a "knack for writing examinations" can produce good marks with a minimum of preparation, another may prepare for six months and not make the grade.

The candidate who can avoid "blowing-up" if he finds himself in difficulty, who can think clearly, work quickly and accurately, and get what he knows down on paper in a concise and mature manner, will be at a decided advantage. This is particularly important if the student realizes that he is probably not writing to a particular standard, but against every other man in the room.

A piece of advice offered to me, and which I believe is sound, is that the candidate should remember that his paper will be marked by a practicing chartered accountant. He should therefore answer the questions with this in mind, and rely to some extent on his own practical experience. After all, auditors' reports are not qualified with the same regularity in actual practice, as they are in the textbooks.

M. C. Govier, C.A.
(*Millar Macdonald & Co.*)

Let Justice Be Done

Montreal, Oct. 12, 1948.

Sir: It has always been understood that expenses *necessarily* laid out to earn the profits of any company are allowable as a deductible expense before ascertaining the taxable profits.

Under a recent regulation from the taxing authorities, it transpires that corporations who have their head offices in either the Province of Quebec or Ontario cannot deduct from their profits any taxes paid to the Provincial Governments for 'Capital and Places of Business'! Surely, this tax is one that *has* to be paid and cannot be avoided in any way such as even a very necessary item as Advertising or Travelling Expenses. If these latter two are curtailed, the business will probably suffer, but on the other hand, they still can be avoided; not so in the case of taxes due to the Provincial Government for Capital and Place of Business.

A large manufacturing concern with a capital of say $200,000,000, has to pay $200,000 for tax on Capital. If that very necessary levy is disallowed, it means that that corporation is thereby compelled to pay an additional $60,000 for Dominion Income Tax, and also Income Tax on the tax for every place of business situated within the two Provinces.

Corporations whose head offices may be in any of the other seven Provinces do not have to pay any such tax, but it does seem very unjust that companies in Ontario and Quebec, who are *compelled* to pay this tax, are not allowed to consider same as a justifiable expense.

Surely the reason cannot be on account of the political opposition of these said two Provincial Governments to a tax agreement plan proposed by the Domin-

ion Government. If so, that would seem to savour very much of the tactics adopted by the Soviet Government.

Adam Smith, in his well-known treatise on public taxes, stated that two of the necessary requirements should be 'equity' and 'consent of the governed'. On these two grounds alone such a method of taxation does appear to be most unjust.

PRACTITIONER.

Professional Notes

Alberta

At the monthly luncheon of the Calgary Chartered Accountants' club, R. J. Snell, C.A. was elected president, J. R. Hardie, C.A. vice-president, and D. R. Redman, C.A. secretary-treasurer.

Ontario

Mr. Charles G. Gale, B.Com., C.A., announces the opening of an office for the practice of his profession at 26 Central Chambers, 46 Elgin Street, Ottawa, Ont.

* * * * *

Messrs. Geo. A. McLeod, C.A. and Edward M. Field, C.A. announce the formation of a partnership under the firm name of Geo. A. McLeod & Company with offices at Room 312, 62 Richmond Street West, Toronto, Ontario.

* * * * *

Mr. J. C. Sutherland, C.A. has been appointed to the staff of Shaw Schools, Toronto, as Assistant to the Director of the Higher Accounting Division.

* * * * *

Mr. Samuel B. Rose, Chartered Accountant, announces the opening of a branch office at 69 Collier Street, Barrie, Ontario, for the practice of his profession.

Quebec

The firm of Rodier, Pesner and Company, 1434 St. Catherine St. W., Montreal, was dissolved as of October 1st, 1948. Their practice has been taken over by Harry L. Rodier, C.A., at the same address.

* * * * *

The firm of Dobrin, Dainow & Company (Montreal), Chartered Accountants, announce that as of October 1, 1948, their practice is continuing under the name of Dobrin, Dainow & Simkover.

British Accountancy Leaders Entertained

The Dominion Association and the Council of the Ontario Institute were honoured recently by having as their guests for luncheon Sir Frederick Alban and Mr. A. A. Garrett, President and Secretary of The Society of Incorporated Accountants and Auditors, who visited Toronto on their way back to England after attending the Annual Meeting of the American Institute of Accountants at Chicago. Both made informal comments on the state of business and the public accountancy profession in the United Kingdom. Messrs. Howson and Glassco shared the privilege of acting as toastmasters.

The Tax Department

Cases • Regulations • Directives • Comment

Edited by M. I. Pierce, B.A., LL.B.

The New T2 - 1948

By G. Moller, D.Jur., C.A.

UNHERALDED by newspaper headlines, alas, not even mentioned on the back pages, the new income tax return form for Corporations has been born and issued by the Department of National Revenue. The form is revolutionary in that it abandons the T2—Questionnaire, combining those questions, which remain relevant with the items formerly contained on the older income and excess profits tax returns. The auditor's close co-operation with the Tax Division is apparently no longer required and there is no provision for the auditor's signature nor for a report by the auditor on the T2 Return or on any of the questions asked therein.*

The new form is not only a combination of the previous return and questionnaire but contains a number of completely new items. For example, Item 4 requires a report on the percentage of the issued shares of the company held by (a) an individual residing in Canada, (b) Canadian corporation or corporations, (c) non-resident individuals or corporations.

The authorized officer of the Company who signs the return has now to state on the form that as an authorized signing officer of the company he has personal knowledge of the affairs of the company and that the return was completed by him or under his supervision for and on behalf of the company.

Page 2 of the return is headed by the ominous words "Read item 10 before completing this form". Turning back to page 1 where Item 10 appears, the company's officer sees that he is certain to risk penalties for failure to file the return in time or for making false or deceptive statements in the return, etc., etc.

Incorporated taxpayers will have in future to attach a number of detailed statements which up to now they were not explicitly required to provide for the Tax Division. One of these will be a breakdown of cost of sales in respect of material, labour and overhead, and of manufacturing, selling and administrative expenses. Others will be statements of deferred charges and of the investments of the taxpayer at the beginning and end of the fiscal period with an explanation of any changes during the period.

Altogether the new form is definitely better arranged than the previous return form and questionnaire, more up to date

* See "Is the T2-Questionnaire still necessary" in the June 1948 issue of *The Canadian Chartered Accountant*, p. 363.

and easier to complete.* Although criticism of some of the detail questions may be in order, the new form certainly deserves to be described as a distinct improvement.

Orders-in-Council — Regulations

ORDER-IN-COUNCIL RESPECTING THE CLASSES OF PLANT AND EQUIPMENT ELIGIBLE FOR DEPRECIATION AT NOT MORE THAN DOUBLE THE NORMAL RATES

P.C. 3882, September 9, 1948

HIS EXCELLENCY the Governor General in Council, on the recommendation of the Minister of National Revenue and pursuant to the provisions of subpara. (ii) of para. (n) of subsec. (1) of sec. 6 of the *Income War Tax Act*, R.S.C. 1927, Chap. 97, is pleased to order as follows:

1. Order in Council P.C. 109 of 25th March, 1947, determining the classes of plant and equipment built or acquired within the period therein set forth which would be subject to depreciation at not more than double the rates normally allowed for taxation purposes, is hereby revoked; and

2. The following Order is hereby made in substitution for the Order which is hereby revoked:

ORDER

1. In this Order, unless the context otherwise requires:

(a) "Act" means the *Income War Tax Act;*

(b) "Minister" means the Minister of National Revenue;

(c) "Corporation" means the Central Mortgage and Housing Corporation;

(d) "rental housing project" means a project having four or more family housing units built for rental purposes consisting of one-family dwellings, or multiple-family dwellings, or a combination of one-family and multiple-family dwellings, together with any public space, recreational facilities and commercial space and buildings appropriate to the project;

(e) "equipment" means all permanent fixtures, fittings, machinery, furnaces, boilers, refrigeration equipment, gas and electric stoves, water heaters, ice boxes, electric light fixtures, window blinds and fixtures, storm and screen doors and windows, plumbing and heating equipment, oil tanks and oil burning equipment, piping, elevators and elevator equipment and, generally, all apparatus and things incorporated in or forming part of the buildings and structures comprising the rental housing projects.

(f) "standard room" means a living room, a bedroom, a dining room or a kitchen. A room used for

* Certain terms as e.g. "Test Physical Count" in item 16 or 26(g) as a whole require clarification by the Department.

two or more purposes will be considered one standard room.

(g) "rates of depreciation normally allowed" means the rates of depreciation allowed by the Minister under the provisions of para. (n) of subsec. (1) of sec. 6 of the *Income War Tax Act* other than special or double depreciation on property of a similar class, as for example:

	Maximum rates per annum Percentage
Buildings (including all component parts, such as electric wiring, plumbing, sprinkler system, etc., contained in such buildings except elevators and boilers):	
Reinforced concrete and transite	2
Brick, brick veneer and stone	2½
Stucco on brick or cement	2½
Stucco on frame	5
Frame	5
Galvanized iron	5
Equipment	
Furnace	same rate as building
Boilers	5
Refrigeration equipment	10
Gas and electric stoves	10
Water heaters	10
Ice boxes	10
Electric light fixtures	same rate as building
Window blinds and fixtures	10
Storm and screen doors and windows	same rate as building
Plumbing and heating equipment	same rate as building
Oil tanks and oil burning equipment	10
Piping	same rate as building
Elevators and elevator equipment	5

2. This Order shall apply to rental housing projects and equipment installed therein where the following conditions are fulfilled:

(a) Construction of the rental housing project is commenced prior to January 1, 1949:

(b) The family housing units of the project:

(i) have an average of not less than 3.5 standard rooms and bathroom;

(ii) have an average of 1.5 bedrooms;

(iii) have an approximate average area of seven hundred square feet. (For calculating the area per unit in a multiple project, the number of units is to be divided into the total floor area (excluding basement used for other than living quarters) measured from the outside face of exterior walls).

(c) (i) The rental to be charged for the housing units is not to exceed $80.00 per month for a fully serviced family housing unit comprising eight hundred square feet; the rental for units varying from this base shall be adjusted by adding seven

cents per month for each square foot by which the area of the unit exceeds eight hundred square feet and by subtracting five cents per month for each square foot by which the unit is less than eight hundred square feet.

(ii) A fully serviced unit is a unit supplied with heating, hot and cold water, stove, refrigerator and full janitor service.

(iii) In addition to the adjustment of rentals for which provision has been made in this section on an area basis, a further adjustment of rentals shall be made to the extent that the unit is not fully serviced.

(d) The owner gives a preference to veterans in the occupancy of completed units.

(e) Where the project is financed in whole or in part by a loan secured by a mortgage and the owner, in addition to the instalments provided for in the mortgage, makes a prepayment to the mortgagee amounting to one-third of the extra depreciation allowed pursuant to this Order; in the event that the mortgagee refuses to accept such prepayment, tender thereof to the mortgagee shall be sufficient to meet the requirements of this subparagraph.

3. The periods during which rental housing projects and equipment installed therein must be built and acquired for the purposes of subpara. (ii) of para. (*n*) of subsec. (1) of sec. 6 of the *Income War Tax Act* and this Order are:

(a) The building of the project and the installation of the equipment must have been accomplished during the period 31st March, 1948, to 31st December, 1949; and

(b) The project built during the period set out in the preceding paragraph must have been acquired by the owner during the period 31st March, 1947, and the 31st December, 1959.

4. Where a project is partially completed in the period fixed by sec. 3, para. (*a*) of this Order, such part thereof as is completed during the said period shall be deemed to be the rental housing project subject to this Order for the purposes of subpara. (ii) of para. (*n*) of subsec. (1) of sec. 6 of the *Income War Tax Act.*

5. In computing the amount of the profits or gains to be assessed under the *Income War Tax Act* or the *Excess Profits Tax Act,* 1940, depreciation may be deducted at the option of the taxpayer in an amount computed at not more than double and not less than one-half the rates normally allowed if the amount is allowed by the Minister pursuant to subpara. (ii) of para. (*n*) of subsec. (1) of sec. 6 of the *Income War Tax Act* and this Order.

6. No depreciation shall be allowed with respect to the rental housing project or any class of equipment installed therein as provided in the preceding section, notwithstanding anything contained therein:

(a) until the project is completed and is producing revenue;

(b) unless the documentary evidence of the costs thereof as required by sec. 9 of this Order is filed with the Minister on or before the due date for the filing of income tax returns of the first year in respect of which double depreciation is claimed as authorized by sec. 6 (1) (*n*) (ii) of the *Income War Tax Act* and this Order;

(c) after the total depreciation allowed to the owner and any preceding owner equals the original cost of the project or equipment;

(d) after ten years from the completion of the project or after the 31st December, 1959, whichever is the earlier in time.

7. No depreciation shall be allowed pursuant to sec. 5 of this Order in respect of any rental housing project or equipment installed therein unless the Corporation has certified that, having regard to the need of rental housing accommodation in Canada, it is desirable in its opinion that depreciation be allowed in respect thereof, as provided by the said sec. 5.

8. The Corporation may at any time, when in its opinion the applicant for depreciation under this Order has ceased to fulfil the conditions contained in sec. 2 hereof, withdraw the certificate provided in sec. 7 of this Order and the Minister will not allow depreciation at double the rates normally allowed for the purpose of assessing income tax and excess profits tax with respect to the said applicant on all assessments made subsequent to the withdrawal of the certificate.

9. The rates of depreciation provided for under this Order shall be applied to the actual costs of constructing the rental housing project and the costs of purchasing and installing the equipment therein during the period 31st March, 1947, to 31st December, 1949, as shown to the satisfaction of the Minister through the production of statements supported by vouchers, receipts and such other evidence as may be required by the Minister.

10. Notwithstanding this Order, the decision of the Minister as to whether depreciation is allowable under subpara. (ii) of para. (*n*) of subsec. (1) of sec. 6 of the *Income War Tax Act* and as to the amount thereof, if any, is final and conclusive.

A. D. P. Heeney,
Clerk of the Privy Council.

Departmental Directives

Directive No. 219

September 24, 1948

From the Deputy Minister (Taxation)

The Yukon Corporation Income Tax Ordinance.

This Department has been advised that the Commissioner of the Yukon Territory, by and with the advice and consent of the Council of the Yukon Territory, has enacted the *Yukon Corporation Income Tax Ordinance.*

The Ordinance imposes, as of 1st January, 1948, a 5% tax on that part of a corporation's income that is attributable, according to the rules set out in the First Schedule of the Ordinance, to the operations of such corporation in the Yukon Territory.

Under the terms of an Agreement entered into by the Governments of Canada and the Yukon Territory, the Ordinance, except as to sections relating to appeals, is to be administered by the Deputy Minister of National Revenue for Taxation.

For the purposes of the Ordinance, the income of a corporation that is taxable

thereunder is its income subject to tax as computed for the purposes of the *Income War Tax Act* of Canada. For fiscal years commencing in 1947 and ending in 1948, the tax otherwise payable by a corporation will be reduced by the pro rata amount, calculated on a daily basis, applicable to income in 1947.

It is provided in the Ordinance that the provisions of the *Income War Tax Act* relating to the making of returns, the payment of taxes, and assessments, or relating to any other matter affecting the administration of that Act (except those provisions relating to appeals), shall, in general, have the same force and effect, for the purposes of the Ordinance, as if enacted therein, except that, in certain circumstances, an extension of time is permitted for the filing of returns and the payment of taxes.

Directives 63, 160, 179 and 186 are to be considered applicable, where pertinent, to the *Yukon Corporation Income Tax Ordinance.*

Inasmuch as the above-mentioned provisions of the *Income War Tax Act* are to have the same force and effect for the purposes of the Ordinance as if enacted therein, the sections of the Provincial Corporation Income Tax Acts referred to in Directive 160 are to be read, where the Ordinance is concerned, as being the corresponding sections of the *Income War Tax Act* as follows:

PROVINCIAL CORPORATION INCOME TAX ACT		INCOME WAR TAX ACT	
Section	4(k)	Section	4(m)
do	4(s)	do	4(x)
do	5(1)(c)	do	5(1)(ff)
do	5(1)(f)	do	5(1)(m)
do	5(1)(h)	do	5(1)(u)
do	5(6)	do	5(11)
do	8(6)	do	8(9)
do	28	do	35(3)

Pending revision, *Form TP7B*—Instalment Remittance Form, and *Form TP.7A*—Interim Receipt, are to be used for the purposes of the *Yukon Corporation Income Tax Ordinance* by typing or writing "Yukon Territory" in the space immediately above "Prince Edward Island". *Form TP2*—Provincial Corporation Income Tax Return, has been amended to provide, in 1948, for the calculation of taxes under the Ordinance.

Office copies of the Ordinance are now available for distribution, and District Offices are requested to requisition without delay for the number of copies needed.

Directive No. 222

October 7, 1948

From the Deputy Minister (Taxation)

Depletion — Industrial Mineral Mines

Order in Council P.C. 2747, dated 17th June, 1948, which extends the rates of depletion allowed in the case of certain natural resources, reads as follows: [see *The Canadian Chartered Accountant* of August, 1948 at pages 105-6]

Examples of industrial minerals occurring in non-bedded deposits are clay, gravel, gypsum, sand, sodium sulphate and peat.

Examples of industrial minerals occurring in bedded deposits are clay, gravel, gypsum, sand, sodium sulphate and peat.

Certain industrial minerals, such as limestone (when used for industrial purposes other than as building stone) and barite occur in either bedded or nonbedded deposits and the determination of the depletion allowance depends upon the nature of the occurrence. A com-

plete statement of facts must be referred, by letter, to the Deputy Minister (Taxation), Ottawa, in order that the basis of depletion to be allowed may be determined.

These regulations in no way replace or alter the specific rates set out in Order in Council P.C. 1046, of 25th March, 1947, as outlined in Directive No. 70.

D. SCULLY
Deputy Minister (Taxation)

Directive No. 225

October 18, 1948

From the Deputy Minister (Taxation)

Convention Expenses of Dental Profession

Effective 1st January 1948, the reasonable expenses incurred by members of the dental profession in attending the following Dental Conventions will be admitted for Income Tax purposes against income from professional fees:

1. One Convention per year of the Canadian Dental Association.
2. One Convention per year of a Provincial Dental Association.
3. One Convention per year of a Dental Society or Association of Specialists in Canada or the United States of America.

The expenses to be allowed must be reasonable and must be properly substantiated; e.g. the taxpayer should show (1) dates of the Convention, (2) the number of days present, with proof of claim supported by a certificate of attendance issued by the organizations sponsoring the meetings, (3) the expenses incurred, segregating between (a) transportation expenses, (b) meals and (c) hotel expenses, for which vouchers should be obtained and kept available for inspection.

None of the above expenses will be allowed against income received by way of salary since such deductions are expressly disallowed by statute.

Recent British Tax Decisions

House of Lords Holds Vendor's Shares Are Taxable Income Even Though Not Realisable

The House of Lords has recently handed down a tax decision in which the main question involved was, in Viscount Simon's words, "one of substantial importance, and of considerable difficulty." The decision is that of *Gold Coast Selection Trust Limited* v. *Humphrey,* reported in [1948] Taxation Reports 253. The facts were briefly as follows:

The Gold Coast Selection Trust Ltd., a British company, carried on the trade of a dealer in stocks and shares and an exploiter of and dealer in gold-mining concessions in the Gold Coast Colony. Its practice was to acquire concessions for land considered to have gold-bearing possibilities, exploit them to the extent necessary to ascertain their potentialities, and where a good prospect was thereby determined to transfer such concession to a public company which would work the concession and market the gold produced. The consideration for the transfer of the concession was in each case satisfied by an issue of fully-paid-up shares in the transferee company, which were of a par value

equal to the price named in the agreement for the sale of the concessions. The Trust Company's share-holdings were large enough to give it control over the transferee company, and were too large to be readily disposed of in the stock market without killing the market, and it appeared that if it was desired to turn the block of shares into cash it was necessary to dispose of them by private sale, but whether or not it could realise the whole block in this way, at any rate within a short time, was not clearly established In accordance with its practice as described the Trust Company, having expended £107,000 in the acquisition and exploitation of a certain concession, sold the concession to the Marlu Gold Ltd. for an agreed price of £800,000, to be satisfied by the issue to the vendor of 3,200,000 paid-up shares of a par value of 5s each. In its books the Trust Co. entered £107,000 (the cost to it of the concession) as the purchase price for the 3,200,000 vendor shares. Then, year by year as shares were sold, the profit on such sales was brought into account.

Held: the vendor shares must be brought into account in the computation of the company's annual profits or gains at their value as at the end of the accounting period in which they were received notwithstanding that they were not realised nor realisable until later. (Viscount Simon, Lords Thankerton, Uthwatt and Du Parcq, Lord Oaksey dissenting).

Per Viscount Simon: "In cases such as this, when a trader in the course of his trade receives a new and valuable asset, not being money, as the result of sale or exchange, that asset, for the purpose of computing the annual profits or gains arising or accruing to him from his trade, should be valued as at the end of the accounting period in which it was received, even though it is neither realised nor realisable till later. The fact that it cannot be realised at once may reduce its present value, but that is no reason for treating it, for the purposes of income-tax, as though it had no value until it could be realised. If the asset takes the form of fully-paid shares, the valuation will take into account not only the terms of the agreement, but a number of other factors, such as prospective yield, marketability, the general outlook for the type of business of the company which has allotted the shares, the result of a contemporary prospectus offering similar shares for subscription, the capital position of the company, and so forth. There may also be an element of value in the fact that the holding of the shares gives control of the company. If the asset is difficult to value, but is none the less of a money value, the best valuation possible must be made. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible. It is for the Commissioners to express in the money value attributed by them to the asset their estimate, and this is a conclusion of fact to be drawn from the evidence before them."

Lord Thankerton agreed in the conclusion, and Lords Uthwatt and Du Parcq concurred in the opinion rendered by Viscount Simon.

Lord Oaksey dissented, being of the view that only those shares which could have been sold in the years of computation should be brought into account at the price they could have fetched.

[*California Copper Syndicate* v. *Harris* (1904) 5 T.C. 159; *Scottish and Canadian Gen. Investment Co.* v. *Easson* (1922) 8 T.C. 265; *John Emery & Sons* v. *C.I.R.* [1937] A.C. 91, 20 TC. 213, explained; *John Cronk & Sons Ltd.* v. *Harrison* [1937] A.C. 185, 20 T.C. 612; *Absalom* v. *Talbot* [1942] A.C. 204, 26 T.C. 166, referred to.]

Permissible Tax Avoidance

In the absence of any reported Canadian cases on the avoidance provisions of the *Excess Profits Tax Act* (sec. 15) and the *Income War Tax Act* (sec. 32A), which have been re-enacted in modified form as sec. 126 of the new *Income Tax Act,* the recent decision of Atkinson J. in a tax appeal on the parallel provision contained in British tax legislation will be of more than usual interest.

The case is *Com'rs of Inland Revenue* v. *Earthwork and Construction Ltd.* [1948] Taxation Reports 193.

The Facts

The respondent company, the Earthwork & Construction Co., was formed by the Oldings Co., who were British agents for certain American manufacturers of caterpillar equipment, to take over and carry on an earth-moving business by means of caterpillar machinery. Oldings held 80% of the shares of the Earthwork Co. and 4 of the 6 directors were nominees of Oldings. The Earthwork Co. obtained some very good government contracts for the making of aerodromes and in the 17 months prior to the transactions in question it paid £40,000 in excess profits tax. However, other companies in the earth-moving business who bought machinery from Oldings complained of the relationship between Oldings and the Earthwork Co., and these complaints reached Oldings' American principals. Oldings thus became anxious to avoid this criticism by at any rate creating the appearance that the Earthwork Co. was going out of business.

By September of 1940 the plant of the Earthwork Co. had been written down to £23,000 and £28,000 had been spent on repairs. At this time it received an offer from an independent company which had just entered the earth-moving business, but which had no skilled staff or experience therein, to purchase the plant of the Earthwork Co. for £60,000. This offer was, however, subject to the condition that some members of the Earthwork Co. (which itself was to be liquidated) should continue to work the plant for another year and that a hire charge of £5,000 per month be paid to the purchasing company for the use of the plant during such year. This offer was accepted in the knowledge that a profit could be made on the government contracts after payment of the hire-charge, and thus Oldings would achieve its object of getting out of the business of earth-moving and at the same time a capital payment of £60,000 would be obtained for the plant, which would be free of tax.

The Earthwork Co. was at once liquidated and a new company was formed, 95% of whose shares were held by Oldings, and the new company carried on in place of the Earthwork Co., completing the government contracts. The new company's standard profit was only £1,000 in place of the Earthwork Co.'s standard profit of £5,570, but, of course the payment of £60;000 hire-charge for the use of the plant during the year reduced the excess profits tax which the Earthwork Co. would have had to pay to a considerably smaller sum paid by the new company.

The Law

The Commissioners of Inland Revenue contended that the transactions described were within the provisions of sec. 35 of the (British) Finance Act, 1941, as amended by sec. 33 of the Finance Act, 1944. This provides:

> "Where the Commissioners are of opinion that the main purpose or one of the main purposes for which any

transaction or transactions was or were effected was the avoidance or reduction of liability to excess profits tax, they may, if they think fit, direct that such adjustments shall be made as respects liability to excess profits tax as they consider appropriate so as to counteract the avoidance or reduction of liability to excess profits tax which would otherwise be effected by the transaction or transactions."

The Special Commissioners, before whom the matter first came (and from whose decision an appeal lies to the Courts only on a question of law), rejected the Revenue's contention. They found that the transaction in question was a genuine business transaction between parties at arm's length, with no collusion of any kind, that the purchase price paid for the plant, viz. £60,000, was not an excessive figure and that the rate for the hire of the plant, viz. £5,000 a month for 12 months, was also a reasonable figure having regard to the large profits to be made in the business and the short time such business would continue.

The Appeal

On appeal to the High Court, Atkinson J. held that there was ample evidence to support the finding that the avoidance of tax was not a consideration. "I have no doubt," he added, "that, when considering the offer and the condition which formed part of it, someone would point out that it made very little difference to them whether they paid their earnings away in excess profits tax or paid a great part of them to [the purchaser] for hire, but that would be merely one of the incidents of the transaction; it was not one of the actuating causes for it; it was not one of the motives."

Further on, he says:

"It must be remembered that a company is not bound to trade for the purpose of earning excess profits tax. A company might very well say to itself: 'Now, shall we buy plant or shall we hire? If we spend £60,000 on plant, all the profit we make except £1,000 [the standard profit] will go in excess profits tax. Why should we spend our capital in that way? We will hire plant and retain our capital, and use the plant for the same purposes as those for which we could have used it if we had bought. We will make the same profits, and instead of the profits all going in excess profits tax a great part of it will go in hire. It makes no difference to us and we are left with our capital intact.' There is no reason in the world why a company should not say that. A company is not bound to trade in a way which will result in heavy taxation, if legitimately it can trade in a different way."

The Judicial Attitude

The excuse for dealing with this decision at such length is that in the absence of any Canadian decisions on the interpretation of the similar provisions in our tax legislation the views expressed by an eminent British jurist may be useful, for while Atkinson J.'s views are not binding on our Courts, and, moreover, the quoted excerpts from his judgment are *obiter dicta,* they afford some basis for assessing the line of thought which will commend itself to the judicial mind practised in the construction of taxing enactments.

One may infer from this decision that a transaction is not to be impeached because it results in the avoidance or reduction of tax unless that result be one of the actuating causes or motives for the transaction.

Our Own Sec. 126

Commencing on January 1, 1949, sec. 126 of the *Income Tax Act,* 1948, c. 53, comes into force with retroactive effect. This provision perpetuates what was thought to be the purely war-time life

of its predecessors, sec. 32A of the *Income War Tax* and sec. 15 of the *Excess Profits Tax Act.* Section 126 contains two important departures from these precursors. Under the latter it was necessary that "the main purpose" of the impugned transaction be the reduction or avoidance of taxation. The new enactment follows the British law as set out above by substituting the requirement "one of the main purposes", thus widening its application. On the other hand, under sec. 126 it is not sufficient that the purpose be merely the avoidance or reduction of taxation; it must be an *"improper"* reduction or avoidance, the apparent effect being to narrow the application of the section. Then, in subsec. (6) of sec. 126 it is declared that "an avoidance or reduction of taxes may be regarded as improper for the purpose of this section *although it is not illegal,"* and this provision will, if anything, extend rather than confine the coverage of this provision.

The Average Man

By G. E. F. Smith, F.C.A.

(Inspiration gained from the writings of Messrs. Blackie, Knowlton and Egerton)

The average man's righteous anger mounts.
He views with suspicion the names of ACCOUNTS.
In doctors and lawyers and plumbers he'll trust,
But doubt all directors he feels that he must.

Now ASSETS he finds has a sinister tone.
If nothing is wrong why not say WHAT WE OWN?
LIABILITIES, too, should certainly go,
It sounds quite evasive — so put WHAT WE OWE.

DEPRECIATION'S a word that's easy to spare;
One can learn from the past and write WEAR AND TEAR.
When REPLACEMENTS are needed be frank and declare
You'll cash the RESERVE if there's any cash there.

What COST OF SALES stands for no layman can tell.
Does it mean what it cost to buy or to sell?
So say it like this — and the whole truth is told —
WHAT IT COST US TO BUY WHAT WE BOUGHT THAT WE SOLD.

And PROFIT AND LOSS — it's surely a crime
To use both these words at the very same time.
How can you make money and lose money too?
No wonder the average man's in a stew.

I don't like to end this poetical book,
That's written so STATEMENTS can get that NEW LOOK;
But before I go on I must know if I can
Expect a good fee from this average man.

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

We distrust the picture of a fixed asset faithfully wearing itself out for the good of the cause and then being suddenly abandoned for some smart young thing with the new look and a fresh coat of paint. Now we ask you, are business men *really* that hard-hearted? We doubt it.

Suppose we look at it this way: Tweedledee buys a new car, puts no repairs on it whatsoever, and trades it in as soon as he begins to mistrust its performance. Tweedledum, who is the more decent of the two, buys a car as a long-term investment and treats it like a king. As the occasion demands he replaces the tires, has it re-painted, uses slip-covers, and finally even replaces the motor. In twenty years' time Tweedledum still drives, officially as it were, a car with the original serial number. Of course by then it will be substantially a different car from the one he purchased. But the terribly important point we want to make is this: the treatment that business men accord their fixed assets reminds us more of Tweedledum than of Tweedledee.

* * * * *

Sometimes students write that profits may be increased or losses reduced by omitting a provision for depreciation. We want to urge upon them that their statement is not precise. One should be careful to say instead that the failure to provide for depreciation increases the *figure* for profits, or something more to that effect. There is a vast difference between "increasing profits" and "increasing the figure for profits" and it is the difference between efficiency and manipulation.

* * * * *

For the benefit of those who may not have read it, we reproduce below an amusing anecdote about depreciation related by Professor Paton in the April 1947 issue of *The Accounting Review.*

> A young lady in the accounting department of a certain business was moving a bookkeeping machine from one room to another. As she came alongside an open stairway she carelessly slipped and let the machine get away from her. It went careening down the stairs, with a great racket, and wound up at the bottom in some thousands of pieces, completely wrecked. Hearing the crash, the office manager came rushing out and he turned rather white when he saw what had happened. "Someone tell me quickly," he yelled, "if that is one of our fully-amortized units." A check of the equipment cards showed that the smashed machine was, indeed, one of those which had been written off. "Thank heaven for that" said the manager.

Solution to Last Month's Puzzle

Let $\$x$ = the value of closing inventory at cost

Then, cost of goods sold $= 6{,}100 - x$

$$\text{Mark-on factor} = \frac{\text{retail value of goods sold}}{\text{cost of goods sold}} = \frac{9{,}000}{6{,}100 - x}$$

Closing inventory at sales value

$$= 150 = \left(\frac{9{,}000}{6{,}100 - x}\right) x$$

$$150(6{,}100 - x) = 9{,}000x$$

$$6{,}100 - x = 60\,x$$

$$x = 100$$

Closing inventory at cost $= \$100$.

* * * * *

Correspondence

Vancouver, B.C.

Sir: As one who wrote the 1947 Intermediate examinations, I have been waiting eagerly for the solution to Question 5, Accounting I to appear in *The Canadian Chartered Accountant.* Now that it has appeared in the July issue I am a little disappointed because there was no explanation given for the treatment of the realization on the sale of the subscription rights in Y Company Limited.

When writing this paper I worried for some time as to how I would answer it. Eventually I credited the $15,000 to the profit and loss account for the following reason:

Assume that X Company Limited takes up all its rights at $110 each and then on the following day sells 2,500 shares on the market, thus leaving it with the same holding in Y Company, i.e., 7,500 shares. Presuming that the market value of Y's shares is about $116, would not the entries effecting these transactions be as follows?

Investment in Y Company Limited	550,000	
To Cash		550,000
To record the purchase of 5,000 shares of Y Company Limited at $110 per share by exercising 5,000 rights.		
Cash	290,000	
To Investment in Y Company Limited		262,500
Profit and loss account		27,500
To record the sale of 2,500 shares of Y Company Limited at $116 per share.		

The credit to the investment account has been arrived at as follows:

	5,000 shares at $100	$ 500,000
	5,000 shares at $110	550,000
	10,000 shares at average $105	1,050,000
less	2,500 shares at $105	262,500
	7,500 shares at $105	787,500

Because I did not think that there would be any doubt in the treatment of the above, I considered that the realization on the sale of the rights would be handled in the same way, that is, as a credit to profit and loss account.

B. D. GRAVES

Editor's Reply

In our opinion most accountants would hesitate to credit the entire proceeds of the sale of subscription rights to profit and loss, although some might regard *part* of the proceeds as current income.

As a background for the discussion which follows, we should understand that as soon as a subscription right (as represented by a "warrant") is issued it acquires a separate market value, provided of course it presents an opportunity to buy a further share at a very favourable price. It then becomes necessary to know whether or not a price quoted on an old share includes this right to subscribe to an additional one. As the right may be traded separately, the share which gave rise to it may be quoted without the right attached (i.e., "ex right"). As soon as all subscription rights are exercised, either by the holders of the original shares or by those to whom they have sold the rights, or as soon as the rights lapse, there is no further problem. All shares are henceforth without rights.

The fact of the subscription right does not in itself add anything to the equity behind the share to which it is attached. In other words, the surplus of Y Ltd., is affected by earnings and not by the issue of subscription rights. The latter event merely suggests from the point of view of the shareholder some allocation of the original share as between the right and the value of the share presently held.

On the other hand, while the holder of the original shares does not receive any additional equity when he receives his subscription rights, he is nevertheless put on notice that he must either take up his rights or see his fractional ownership decreased. If he sells his rights he should therefore regard the proceeds as compensation for the sacrifice he has made.

Finney in his third (1946) edition of Intermediate Accounting suggests from the point of view of the shareholder a means of determining the maximum portion of the proceeds of the sale of subscription rights which may be credited to revenue. Its basis is the relative market prices of subscription rights and shares (ex rights) and is explained by him at page 399 as follows:

> After the warrants are issued and the stock is selling ex rights, problems arise which require an apportionment of the cost of the original stock between the stock and the rights; this is done on the basis of the market value of the right and the market value of the stock ex rights at the time of the issuance of the rights.

Cost of share of stock		$100
Market values on date of issuance of rights:		
Right	$30	
Stock ex right	120	
Total	150	
Apportionment of $100 cost:		
Right 30/150 of $100		20
Stock 120/150 of $100		80

Finney then goes on to say that if the holder *exercises* his right, the value of the right merely changes its allegiance. It associates itself with the cost of the new share acquired (as now included in stock investment account) instead of with the

old share. This however is of no consequence in considering the total cost of both new and old shares. Stock investment account is simply debited with the cost (here, the issue price) of the new share.

If, on the other hand, the holder *sells* his right, the entry would be

Dr.	Cash	30	
	Cr. Stock investment account		20
	Cr. Profit on sale of right		10

which reduces the balance in stock investment account to $80 in respect of the share to which the right had been attached.

It is apparent that the examination question to which you refer does not contemplate the type of allocation recommended by Finney since we are told neither the cost of the investment in Y Ltd., nor the market value of the stock ex right. The only possible apportionment of the cost of the investment in Y Ltd., from the information available is to suppose that it consists of an equal number of shares and rights with the rights worth $6 each and the shares worth the balance. This is the theory of the solution published.

We do not agree with the suggestion of your last paragraph that there is no doubt as to the treatment of "profit" on a partial sale of investment holdings. As a matter of fact there has been considerable discussion on the problem among accountants. It may be possible to sell part of the shares held at a unit price above that which could be obtained if the entire block were offered for sale at one time. Quoted market prices for securities are frequently based on day-to-day trading in small lots. The extent to which the offer of a large block of shares may "break" the market is not always appreciated, although it must vary of course with market conditions.

In any event, there is a school of accountants which would not recognize any profit until the entire cost had been recovered from the sale of the shares. In the meantime they would credit the proceeds of partial sales entirely to stock investment account. Other accountants again might not take such an extreme position but would regard the "profit" as a suspense item and refuse to consider the transaction completed until it is ascertained that the entire holding will be sold profitably.

This matter has been of special concern for investment trusts which make it their business to invest funds provided by investors in a variety of securities: the assets of an investment trust are nearly all investments in other companies. It is generally agreed that this situation calls for a careful distinction between income from interest and dividends on investment holdings and income representing profit on the sale of shares or subscription rights. Any dividends which are declared for the latter reason should, it is urged, at least be clearly labelled as to their source. (See the recommendations of the Listing Committee of the New York Stock Exchange as quoted in Smails "Auditing" bottom page 310, and top page 311).

* * * * *

Problems and Solutions

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

Problem 1

INTERMEDIATE EXAMINATION, DECEMBER 1947

Accounting II, Question 4 (15 marks)

With respect to the following classes of items, what are the requirements of the Dominion Companies Act for disclosure on the annual financial statements:

(1) Accounts receivable
(2) Inventories
(3) Investments (other than investments in subsidiary or affiliated companies)
(4) Fixed assets
(5) Capital stock
(6) Earnings of and dividends received from subsidiaries, where consolidated statements are not presented.

Solution

(1) *Accounts receivable*

Debts owing to the company by its directors, officers or shareholders should be shown separately. Other debts owing to the company should be set out in the balance sheet, and where estimated loss is not provided for, current accounts should be distinguished from non-current accounts.

(2) *Inventories*

Inventories should be shown separately from other classes of assets and the basis of valuation, and the manner in which such value has been determined in respect of the various subdivisions of inventory, should be stated.

(3) *Investments (other than investments in subsidiary or affiliated companies)*

Investments should be shown separately from other classes of assets. The nature of the investments should be stated and the market value of marketable securities and the book value of other securities shown separately.

(4) *Fixed assets*

Fixed assets should be shown separately from other classes of assets, stating the basis of valuation, whether cost or otherwise.

If these assets are valued on the basis of an appraisal the date of appraisal and the name of the appraiser must be shown and if the surplus of the company has been increased as a result of the appraisal, the amount by which such assets were written up within a period of three years prior to the date of the balance sheet.

(5) *Capital Stock*

The amount of shares of each class issued and outstanding and the amount paid thereon.

The amount of each class of shares issued since the last balance sheet for services rendered, commissions, or assets acquired since the date of the last balance sheet. If any preferred shares have been issued, a sufficient description of such shares to indicate that they are liable to be redeemed.

The information shown must also set out, where applicable, the amount received upon the issue of shares which is (a) attributable to capital and (b) set aside as distributable surplus.

(6) *Earnings of and dividends received from subsidiaries where consolidated statements are not presented*

The balance sheet must have annexed to it a statement signed by the auditors stating how the profits or losses of such subsidiary, or if more than one the aggregate profits or losses of such subsidiaries, have been dealt with, and in particular to what extent:

(a) provision has been made for losses of the subsidiary, and

(b) such losses have been taken into account in arriving at the profit or loss of the holding company.

It is not necessary, however, to specify the actual amount of the profits or losses of any subsidiary or the amount of such profits or losses which have been dealt with in any particular manner.

If the losses, or, if more than one subsidiary, the aggregate of losses less profits of all subsidiaries, have not, in the opinion of the auditor of the holding company, been fully provided for, the auditor must state the additional amount which is required to make full provision; and if the amounts treated as income received from the subsidiary or subsidiaries, in the opinion of the auditor exceed the profits of the subsidiary or the aggregate of profits less losses of the subsidiaries, the auditor shall state his opinion as to the amount of such excess.

Problem 2

FINAL EXAMINATION, DECEMBER 1947

Accounting III, Question 4 (15 marks)

A Company Limited's balance sheet as at 31st December, 1946 appeared as follows:

Assets

Current			
Cash		$ 500	
Accounts receivable	$ 35,000		
Less bad debts reserve	2,000		
		33,000	
Notes receivable		10,000	
Inventories		25,000	
			$ 68,500
Fixed Assets			
Land		$ 15,000	
Building	$ 60,000		
Less depreciation reserve	20,000		
		40,000	
Machinery and equipment	$ 60,000		
Less depreciation reserve	30,000		
		30,000	
Office furniture *less* depreciation		5,000	
			90,000
Prepaid Insurance			400
			$158,900

Liabilities

Current		
Accounts payable	$ 50,000	
Notes payable	25,000	
Accrued interest—Notes	1,250	
Mortgage bonds	3,000	
		$ 79,250
Funded Debt		
6% bonds, first mortgage, on land and buildings		50,000
Share Capital	$100,000	
Less deficit	70,350	
		29,650
		$158,900

On the same date it was decided to liquidate. This process took six months, during which time the following transactions took place.

Accounts receivable realized $32,000.

Notes receivable collected in full plus interest of $300.

Inventories realized $25,500.

Land and buildings brought $53,000 and the plant and machinery $27,000.

The office furniture was taken by a creditor for $4,000.

On cancellation of insurance, the company received $300.

All liabilities were settled in full, together with additional interest on notes and bonds $1,000.

Liquidation expenses were $1,000.

Required:

Prepare a realization and liquidation account and trustees' cash account.

Solution

A COMPANY LIMITED

Realization and Liquidation Account

for the period 31st December, 1946 to June 30th, 1947.

Assets to be realized		
Accounts receivable	$ 33,000	
Notes receivable	10,000	
Inventories	25,000	
Land	15,000	
Buildings	40,000	
Machinery and equipment	30,000	
Office furniture	5,000	
Insurance	400	$158,400
Supplementary charges		
Interest on bonds and notes payable	$ 1,000	
Expenses	1,000	2,000
Liabilities liquidated		
Accounts payable	$ 50,000	
Notes payable	25,000	
Accrued interest	4,250	
First mortgage bonds	50,000	129,250
		$289,650
Liabilities to be liquidated		
Accounts payable	$ 50,000	
Notes payable	25,000	
Accrued interest	4,250	
First mortgage bonds	50,000	$129,250
Supplementary credits		
Interest		300
Assets realized		
Accounts receivable	$ 32,000	
Notes receivable	10,000	

Inventories	25,500	
Land and buildings	53,000	
Plant and machinery	27,000	
Office furniture	4,000	
Insurance unexpired	300	151,800
Loss on realization		8,300
		$289,650

Trustees' Cash Account

1947			
Jan. 1	To Cash on hand	$ 500	
June 30	" Realization of accounts receivable	32,000	
	" Realization of notes receivable	10,000	
	" Interest on notes receivable	300	
	" Realization of inventories	25,500	
	" Realization of land and buildings	53,000	
	" Realization of plant and machinery	27,000	
	" Cancellation of insurance	300	
	By Accounts payable		$ 46,000
	" Notes payable		25,000
	" Accrued interest—notes		1,250
	" Accrued interest—mortgage bonds		4,000
	" Liquidation expenses		1,000
	" Funded debt		50,000
	" Balance		21,350
		$148,600	$148,600

Available for Shareholders:—		
Share capital		$100,000
Deduct Deficit	$ 70,350	
Loss on realization	8,300	78,650
Cash on hand, as above		$ 21,350

Problem 3

FINAL EXAMINATION, DECEMBER 1947

Accounting III, Question 5 (5 marks)

(a) For executorship purposes indicate whether the following items are of a capital or income nature:

1. Stock dividends.
2. Brokerage charges on investments purchased or sold.
3. Taxes on unproductive real estate.
4. Interest on loan to pay succession duty.
5. Losses incurred in carrying on a business.

(b) If any doubt exists that any item, either receipt or payment, is capital or income, what is a good rule to follow?

Solution

Generally speaking, the items in the absence of special circumstances, should be treated as follows:—

(a) 1. Capital
2. Capital
3. Capital
4. Income
5. Income

(b) A good rule to follow is to treat a receipt as capital and charge payments to income. By so doing, the executor frees himself from a possible over-payment of income which, in most cases, is paid out prior to a distribution of capital. Where serious doubt exists, or where the amount involved is substantial, application should be made to a probate judge for a ruling.

Problem 4

FINAL ACCOUNTING, DECEMBER 1947

Accounting III, Question 6 (25 marks)

The A Company owns 90% of the stock of B Company, and takes up its share of the subsidiary's profits, losses and dividends through its investment account.

Trial balances of the two companies as at 31st December, 1946, are as follows:

Debits

	A Company	B Company
Cash	$ 45,500	$ 4,000
Accounts receivable	130,000	65,000
B Company	35,000	
Inventory	58,000	50,000
Fixed assets	235,000	105,000
Goodwill	40,000	
Investment in B—Shares	60,000	
Bonds at par	15,000	
Sinking fund		5,000
Cost of sales	575,000	215,000
Expenses	170,000	60,000
Loss of Company B	4,500	
Dividends paid	25,000	3,000
	$1,393,000	$ 507,000

Credits

	A Company	B Company
Accounts payable	$ 65,000	$ 40,000
A Company		15,000
Depreciation reserve	90,000	10,000
Bonds payable	150,000	50,000
Capital stock	250,000	100,000
Surplus, 1st January, 1946	38,000	22,000
Sales	800,000	270,000
	$1,393,000	$ 507,000

The $20,000 difference in the intercompany accounts is due to the following debits to B account in the books of Company A:

31st Dec., 1946	Sinking fund deposit made for B Company on their guaranteed bonds	$ 5,000
	Sale to B Company not received by it until 1947 (Cost $11,000)	15,000

Required:

Prepare consolidated working papers and statements.

Solution

Adjustments

1.	To record sinking fund deposit	$ 5,000
2.	" reverse sale to B. Company	15,000
3.	" restore inventory value	11,000

Eliminations

A.	Capital stock of B	$90,000
B.	Loss of company C	4,500
C.	Transfer of current account	20,000
D.	Dividend paid by B	2,700

A COMPANY LIMITED

Consolidated Statement of Profit and Loss

for year ending 31st December, 1946.

Sales	$1,055,000
Less cost of sales	779,000
Gross Profit	$ 276,000
Deduct Expenses	230,000
Net income	$ 46,000
Add minority interest in subsidiary's loss	500
Consolidated net income for 1946	$ 46,500

A COMPANY LIMITED

Consolidated Statements of Earned Surplus

for year ending 31st December, 1946.

Balance at credit, 1st January, 1946	$38,000
Add consolidated income for 1946	46,500
	$84,500
Deduct dividend paid	25,000
Balance at credit, 31st December, 1946	$59,500

A COMPANY LIMITED

Consolidated Balance Sheet as at 31st December, 1946.

Assets

Current		
Cash	$ 49,500	
Accounts receivable	195,000	
Inventory	119,000	$363,500
Sinking fund		10,000
Fixed assets	$340,000	
Less depreciation reserve	100,000	240,000
Goodwill		40,000
		$653,500

Liabilities and Capital

Current liabilities			
Accounts payable			$105,000
Bonds payable			
A Company	$150,000		
B. Company	50,000	$200,000	
Less Bonds in treasury		15,000	185,000
Minority interests			11,400
Total liabilities			301,400
Capital and surplus			
Share capital		$250,000	
Earned surplus		59,500	309,500
Capital surplus, representing excess of interest acquired in Company B over purchase price of Company B shares			42,600
			$653,500

(*See Consolidated Working Papers, pages 277-278*)

Conference to be held by Canadian Tax Foundation

The Canadian Tax Foundation is holding its second conference at the Chateau Laurier, Ottawa, on November 22 and 23. The programme sets out selected questions arising under the Federal income tax and succession duty legislation for discussion in general sessions and panel groups.

The Minister of Finance will address the closing dinner meeting as guest of honour. Speakers on other parts of the programme will include Norris Darrell, partner in the firm of Sullivan & Cromwell of New York City, H. H. Stikeman, chairman of the Tax Section, Canadian Bar Association, and A. R. Courtice, assistant general manager of the Toronto General Trusts Corporation.

Internal Auditors Elect Canadian President

Mr. Arthur J. E. Child, B.Com., has brought honour to Canada and himself by his election to the presidency of the Institute of Internal Auditors, Inc. This Institute has constituent chapters in the United States, the Philippine Islands, Canada, and Great Britain. The convention was held in Chicago in September. Mr. Child is a graduate of Queens University and is assistant treasurer of Canada Packers Limited, Toronto.

COMPANY A and SUBSIDIARY.

Consolidated Working Papers—31st December, 1946.

Profit and Loss

	Company B	Company A	Adjustments and Eliminations Dr.	Cr.	Minority	Consolidated
Sales	$800,000	$270,000	2. $15,000			$1,055,000
Less Cost of sales	575,000	215,000		3. $11,000		779,000
Gross profit on sales	$225,000	$ 55,000				$ 276,000
Expenses	170,000	60,000				230,000
Net profit or loss	$ 55,000	$(5,000)				$ 46,000
Loss of B. Company—90%	4,500			B. 4,500		
Minority interest—10%					$ (500)	500
Net income to surplus	$ 50,500	$(5,000)	$15,000	$15,500	$ (500)	$ 46,500

Surplus

	Company B	Company A	Adjustments and Eliminations Dr.	Cr.	Minority	Consolidated
Balance, 1st January, 1946						
—Company A	$ 38,000		$19,800		$ 2,200	$ 38,000
—Company B		$ 22,000	15,000	$15,500		
Net income from profit and loss	50,500	(5,000)			(500)	46,500
	$ 88,500	$ 17,000	$34,800	$15,500	$ 1,700	$ 84,500
Dividends paid—Company A	25,000					25,000
—Company B		3,000		D. 2,700	300	
Surplus, 31st December, 1946	$ 63,500	$ 14,000	$34,800	$18,200	$ 1,400	$ 59,500

A COMPANY and SUBSIDIARY.

Consolidated Working Papers—31st December, 1946.

Balance Sheet

	Company A	Company B	Adjustments and Eliminations Dr.		Adjustments and Eliminations Cr.		Minority	Consolidated
Assets								
Cash	$ 45,500	$ 4,000						$ 49,500
Accounts receivable	130,000	65,000						195,000
B Company	35,000				2.	$15,000		
					C.	20,000		
Inventory	58,000	50,000	3.	$11,000				119,000
Fixed assets	235,000	105,000						340,000
Goodwill	40,000							40,000
Investment in B—Shares	60,000							
Eliminate—Capital stock—90%					A.	90,000		
—Surplus			B.	4,500		19,800		
			D.	2,700				(42,600)
—Bonds	15,000							15,000
Sinking fund		5,000	1.	5,000				10,000
	$618,500	$229,000						$725,900
Liabilities								
Accounts payable	$ 65,000	$ 40,000						$105,000
A Company		15,000	C.	20,000	1.	5,000		
Depreciation reserve	90,000	10,000						100,000
Bonds payable	150,000	50,000						200,000
Capital stock—Company A	250,000							250,000
—Company B		100,000	A.	90,000			$10,000	
Surplus	63,500	14,000		34,800		18,200	1,400	59,500
Minority interest							$11,400	11,400
	$618,500	$229,000		$168,000		$168,000		$725,900

DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

LIST OF AVAILABLE PUBLICATIONS

The Canadian Chartered Accountant

(Published Monthly)

Official organ of The Dominion Association of Chartered Accountants

$4.00 a year

Brochures

Accountants and the Law of Negligence Summerfield and Reynolds (1940) 72 pp.	1.00
Audit Procedure for the Junior Audit Clerk (February 1944) 150 pp.	1.00
Principles of Bookkeeping J. R. M. Wilson (February 1944) 21 pp.	.25

Examination Material

Examination Papers:

December 1945 Intermediate and Final	.25
December 1946 Intermediate and Final	.25
December 1947 Intermediate and Final	.25

Examination Problems and Solutions:

Volume VI, 68 pp.	.35
Volume VII, 76 pp.	.35

Accounting and Auditing Research Bulletins

No. 1	A Statement of Standards of Disclosure in Annual Financial Statements of Manufacturing and Mercantile Companies (available in French or English)	.10
No. 2	A Statement of the Minimum Standards of Professional Practice Which Should Apply in Respect of Prospectuses (available in French or English)	.10
No. 3	The Accounting Treatment of Income Taxes In Some Special Circumstances	.10

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